Condominium Financing

Thomas H. Fegan
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The condominium concept is currently being applied in an ever-increasing variety of ways. Among the residential applications are units for single owner occupancy, units for part-time or vacation occupancy (often with provisions for rental when the unit is not being occupied by the owner) and units divided among various owners on a time period basis ranging down to two-week periods. Nonresidential condominium ventures include motels, hotels, office buildings, professional offices, shopping centers, industrial parks and multiple-use condominiums.1 Obviously, the type, amount and sources of financing available will vary according to the type of condominium project. This paper will primarily cover the financing of conventional residential units for occupancy, on a permanent or semi-permanent basis, by a single owner. At the present time, the overwhelming majority of condominiums are in this category.

The initial application of the condominium concept in the United States was to traditional forms of residential housing. This was probably the result of the impetus given to this concept by the Federal Housing Administration in developing and publishing forms acceptable to the FHA for federally-insured residential unit loans.2 Lending institutions, accustomed to financing apartment buildings and single-family homes, were initially willing to make loans secured by condominium units provided the units were in buildings with the outward appearance of an apartment house, or were residences in a familiar housing setting. In addition, it was generally required that the borrower intend to occupy the unit as his permanent or primary residence.

EARLY LENDING POLICIES

Savings and Loan Associations were the pioneers in financing the first residential developments, making both the construction and unit

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1 Such projects offer attractive advantages to the developer as well as the unit purchaser and are expected to cause the greatest growth in the area of condominiums. For a discussion of industrial and commercial condominiums, see IA P. Rohan & M. Reskin, CONDOMINIUM LAW AND PRACTICE § 21.01 et seq. (1974) [hereinafter cited as Rohan & Reskin].

2 The passage of the Housing Act of 1961 was a major impetus for the flood of state condominium enabling legislation. The Act, as amended in 1964, authorized the Federal Housing Administration (FHA) to insure mortgages on family units in multifamily projects, and blanket mortgages covering multi-family projects to be constructed or rehabilitated and converted to condominium ownership. 12 U.S.C. § 1715y (1970).
loans on what are now considered to be fairly small projects. The success in marketing the first units and the substantial profits realized by developers encouraged larger projects and resulted in a heavier demand for funds. As a consequence, banks and insurance companies entered the field.

The approach of institutional lenders to condominium financing was cautious. Banks were interested in construction lending and insurance companies sought to finance the permanent unit. There was some cooperation between the two, but each sought protection in the event the project was unsuccessful as a condominium. This was especially true of high-rise condominium apartment financing. Consequently, construction lenders appraised a multi-story apartment project on the basis of its market value as a rental apartment building, limited loan amounts to $66 \frac{2}{3}$ or 75 percent of such appraised value, and required that the developer’s equity share of the cost of construction be invested in the project before the first advance under the construction loan.

To insure broader protection for these construction lenders, the developer was required to insert a provision in his unit sales contracts governing his right to cancel such contracts unless a minimum percentage (usually 51 to 75 percent) of the units were sold. The construction lender required the minimum sales level to be met before it would release units from the lien of the construction mortgage. Thus, the lender could prevent the condominium from becoming effective until it was evident that the project would be successful as a condominium. In the event that it was not successful, the construction lender’s investment would not be in excess of an amount that was adequately secured by the appraised value of the property as a rental project.

In addition, the developer was forced to obtain a takeout commitment from another lender covering the permanent unit loans to purchasers of the units. In order to ensure that its participation in the project would end by a specific date, the construction lender also required that the takeout lender make individual unit loans to the developer on all units remaining unsold as of that date. Lenders issuing takeout commitments for loans to purchasers of the individual units usually provided that no loan would be made until a stated minimum percentage of the units were under firm contracts of sale. The percentage required was usually the same as that required by the construction lender, as described above. Like the construction lender, the unit lender was reluctant to make any loan until it was assured that the condominium project was successful. It would not, of course, make
a unit loan until the unit was released from the lien of the construction mortgage.

In many cases loan commitments did not mesh. As a result, the so-called "gap" loan was developed to cover the period between the mandatory maturity date of the construction loan and the date when a sufficient number of units were sold to satisfy the requirements of the takeout unit lender.

While the foregoing description is written as though these conservative lending policies are no longer in effect, this is not entirely the case. To be sure, competition for loans and the increasing confidence of lenders in condominium developments in many sections of the country have caused extensive modifications of these policies. But, whenever a lender has any reservations about the success of a project, a developer can expect conservative loan commitments with restrictions designed to protect the lender. This is especially true in sections of the country where the condominium concept is still fairly new.

**Current Lending Policies**

Developers have always sought to minimize the amount of their own money that must be invested in their projects. Their aim has been to obtain loans that cover construction costs completely and, whenever possible, a sum in excess of that amount. The less equity money required, the more projects they can have under construction. In some geographic areas lending policies have been relaxed to the point where lenders are willing to appraise a condominium project on the basis of the aggregate of the projected sale prices, rather than as a rental project. This has been a boon to developers and has contributed to the great number of condominium projects completed or under construction in those areas.

A developer able to obtain a construction loan of 75 percent of the appraised value computed on unit sales prices will obtain all, or substantially all, of the cost of construction. In many current condominium projects in the more receptive geographic areas, the same lender will finance the entire project, making both the construction loan and the takeout unit loans. This has considerably simplified the financing problems of developers.

The following is a fairly representative comparison of costs of a typical project, if we keep in mind that an appraisal of an apartment building project assumes a profit return on cost over the life of the building based on projected rents, and that an appraisal of a com-
parable condominium project based on projected sales prices includes the developer's immediate profit resulting from the sale of the units:

<table>
<thead>
<tr>
<th>Project Components</th>
<th>Aggregate Costs Condominium</th>
<th>Aggregate Costs Conventional Rental Development</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated direct construction costs, including land, appliances, carpeting, draperies, landscaping, architect and engineering fees</td>
<td>$13,417,000</td>
<td>$13,417,000</td>
</tr>
<tr>
<td>Interim and takeout financing fees and interim interest</td>
<td>1,251,000</td>
<td>820,000</td>
</tr>
<tr>
<td>Advertising and promotion</td>
<td>100,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Leasing commission</td>
<td>—</td>
<td>100,000</td>
</tr>
<tr>
<td>Insurance; survey, legal, accounting and appraisal fees; real property tax; contingencies, etc.</td>
<td>—</td>
<td>119,000</td>
</tr>
<tr>
<td>Sales commission; advertising and promotion; legal, insurance, survey, accounting and appraisal fees; title insurance and escrow fee; real property taxes; developer's profit</td>
<td>2,951,000</td>
<td>Not Applicable</td>
</tr>
<tr>
<td>TOTAL PROJECT COST COMPONENTS:</td>
<td>$17,719,000</td>
<td>$14,476,000</td>
</tr>
</tbody>
</table>

The recent proliferation of Real Estate Investment Trusts (REITs) has contributed to the competition for construction loans of all kinds. REITs that invest in mortgages actively compete for short-term high interest condominium construction and "gap" loans.

It is not unusual for a developer and lender to work out variations from the standard financing patterns. In some cases, the lender will agree to a less-than-market interest rate on a condominium construction loan in return for a share in the profit of the venture. In other cases, financing institutions and developers have entered into joint venture arrangements, with the financing institution furnishing all of

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3 A Real Estate Investment Trust is a creature of tax law. It is an unincorporated trust or association which would be taxable as a domestic corporation except for special provisions of the Internal Revenue Code. It is initially funded through the private or public sale of shares and, in addition to the investment of the proceeds of such funding, it can obtain bank loans at approximately the prime rate, which it invests at several points above the prime rate. See INT. REV. CODE OF 1954, §§ 856-58 and the regulations thereunder, Treas. Reg. §§ 1.856-1 to 1.858-1 (1962).
the funds required for land acquisition and construction and the developer furnishing the expertise necessary to complete the project, with varying percentages of the profit shared by the financing institution and the developer.

In some states, a developer is permitted to use the earnest money deposits of unit purchasers in the construction of condominium projects. In Florida, for example, if the contracts for the sale of the units so provide, the developer, after filing a notice of commencement, may use such deposits in the actual construction and development of the condominium. Florida requires a legend covering this right to be printed or clearly stamped on the face of the contract immediately above the place for signature of the buyer. Such legend is to be in boldface capital type larger than the largest type used in the text of the contract, and in no event less than 20-point type. Since these are interest-free funds, a developer can substantially reduce his financing cost if his sales program results in volume sales prior to or during construction.

**Evaluation of a Conventional Condominium Loan Application**

When applying for a loan for development of a condominium, the following questions are likely to arise in regard to the different areas of a lender's concern:

1. **The Developer** — What is his credit worthiness? Does he have substantial funds of his own, or is he operating with limited capital? What other projects has he completed and with what success?

2. **The Property** — Where is it? Is it in an area where condominiums have been generally successful? If the project is to be a high-rise, is the property in an apartment building area? If the development is a garden apartment type, is the land in a geographically compatible area? Are utilities and other amenities (sewerage, water, transportation facilities, schools, religious facilities, shopping, etc.) of sufficient capacity available?

3. **The Market** — What is the vacancy factor for condominiums and apartment buildings in the area? What competing projects are in

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4 The majority of state statutes, however, either do not address the problem or explicitly require that earnest money of prospective purchasers be deposited in a trust account and not used by the developer prior to the consummation of the sale. Hawaii and New York fall into this latter category. See HAW. REV. STAT. § 514-14 (1968); N.Y. GEN. BUS. LAW § 352-h (McKinney 1968) (which provides, in addition, that any attempted waiver is absolutely void).

5 FLA. STAT. ANN. § 711.25(2) (Supp. 1974).

6 Id.
construction or planned? What are the rental rates for comparable apartments? Are the proposed sales prices of the units competitive? If there have been prior unsuccessful projects in the area, why?

(4) The Improvements — What will be the quality of construction? What are the subsurface conditions (as determined by soil tests)? What is the current density of land use? What will be the probable environmental effects of the construction? To what extent are the plans and specifications complete? What will be the size of the units — both in area and number of rooms? What will be the common area improvements (clubhouse, swimming pool, tennis courts, etc.), and how does the developer intend to handle them?

(5) The Financing — What type of financing does the developer want — a land loan, a construction loan, a "gap" loan, takeout unit loans? What percentage of cost does the developer intend to cover with his own funds? Can the purchaser's deposits be used as a part of the construction cost? What is the cost of the project and how has it been verified? Have the contractor's construction costs been broken down? What are the land acquisition costs, taxes and interest during construction, advertising and sales expenses and projected profits? Over what period will units be sold?

(6) The Documentation — Is the project, as established by the documents, fair to unit purchasers? Do the documents protect a mortgage lender's position during construction and as a unit lender? Are they satisfactory from a legal standpoint? Are there any factors which will require Securities Exchange Commission (SEC) registration? Are

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7 See note 4 and accompanying text supra.

8 The general procedure called for by the statutes of most states for the establishment of a condominium involves the use of three basic documents: the declaration or master deed, the bylaws, and the individual unit deeds. A number of jurisdictions impose additional requirements, such as the filing of plats or maps locating the units and describing the property and improvements in more or less detail. New York's statute, which requires the filing of an offering plan with the Attorney General, contains the most detailed provisions for additional documentation. See N.Y. Gen. Bus. Law § 352-c (McKinney 1968) and the regulations pursuant thereto, 13 N.Y.C.R.R. §§ 19.1-19.5 (1964).

9 Guidelines as to the applicability of federal securities laws to offers and sales of condominiums may be found in SEC Securities Act Release No. 5347 (Jan. 4, 1973). Relying on the definition of an investment contract set down by the Supreme Court in SEC v. W.J. Howey Co., 328 U.S. 293 (1946), the SEC determined that offerings of condominium units in conjunction with any of the collateral arrangements listed below may cause the offering to constitute an offering of investment contracts or interests in a profit-sharing agreement under the federal securities laws:

   (a) offering of participation in a rental pool arrangement;
   (b) offering of a rental or similar arrangement whereby the purchaser must hold his unit available for any part of the year or use an exclusive renting agent or whereby he is otherwise materially restricted in the occupancy or rental of his unit;
   (c) offering of a rental arrangement or other similar service with emphasis on the
there any factors which will require state or Interstate Land Sales registration? What type of advertising does the developer intend to use? Notwithstanding the condominium documentation, as such, will the advertising create any problems with the SEC or other regulatory agencies? If the developer intends to advertise and sell in the State of New York, have provisions been made for the drafting of an offering plan to be submitted to the Attorney General?

benefits to be derived by the purchaser from efforts of the promoter or a third party in connection with rental of the units.


A land developer is required by the Interstate Land Sales Full Disclosure Act, 15 U.S.C. § 1701 et seq. (1970), to make full disclosure in the sale or lease of undeveloped subdivided land. The Act covers the sale or lease of almost any undeveloped real property, including sales of condominium units and commercial lots, as well as primary and recreational residential lots. Patterned after the Securities Act of 1933, the Act requires that a Statement of Record be filed with the Office of Interstate Land Sales Registration (OILSR) and a Property Report be properly furnished to all potential purchasers and lessees. 15 U.S.C. § 1703 (1970). In order for a condominium unit sale to be exempt from the registration requirements of the Act, construction must be completed before it is sold, or it must be sold under a contract obliging the seller to erect the unit within two years from the date the purchaser signs the contract of sale. 15 U.S.C. § 1702(a)(8) (1970); 24 C.F.R. § 1710.10(c) (1973). Condominiums which are intended for use as primary residences in metropolitan areas are generally not subject to registration with OILSR as the professional builders are usually able to erect the project within the stipulated two-year period, thus taking advantage of this exemption.

In addition to registration with OILSR, a developer may often be required to comply with state subdivision regulations. Since there is no uniform law on the subject, the developer will have to comply with the law of the particular jurisdiction in which he is planning his development. The statutes of some states specifically make subdivision regulations applicable to condominiums. See, e.g., ALASKA STAT. § 34.07-060 (1971). Other state statutes are silent on the issue. See, e.g., MISS. CODE ANN. §§ 896.01-.21, 3374.123 (Supp. 1972); (neither the condominium statute nor the subdivision regulations mention the applicability of subdivision controls to condominium projects). A third group of state statutes expressly exclude condominium developments from the scope of their subdivision control acts. See, e.g., MASS. GEN. LAWS ANN., ch. 183A, § 15 (Supp. 1974); N.Y. REAL PROP. LAW § 339-ee (McKinney 1968).

Disseminating sales literature or advertising in connection with offerings or sales covered under the Securities Act of 1933, prior to the filing of a registration statement with the SEC, would constitute an illegal offer under section 5(c). SEC Securities Act Release No. 5382 (Apr. 9, 1973). Also, the regulations of the Office of Interstate Land Sales Registration include provisions governing advertising and sales practices. 38 Fed. Reg. 23,897 (1973).

In New York, even after the condominium offering plan has been accepted for filing by the Attorney General, the sponsor must from time to time submit for approval all advertising material used in connection with the project. See N.Y. GEN. BUS. LAW § 352-e(3) (McKinney 1968).

Pursuant to New York's Blue Sky Law, the New York Department of Law has the authority to regulate any "public offering or sale in or from the state of New York of securities constituted of participating interests or investments in real estate . . . ." N.Y. GEN. BUS. LAW § 352-e(1) (McKinney Supp. 1973). The regulatory powers of the Department apply not only to projects located in New York, but to any project which was advertised or promoted in the state. The sponsor is required to submit for filing the offering plan and all advertising material to be used in connection with the offering.
LEASEHOLD CONDOMINIUMS

The amount and sources of mortgage financing are more limited for residential condominiums constructed upon a leasehold than for those constructed upon land owned in fee simple. Some institutional lenders are not authorized to make leasehold loans; others, though authorized, will not make them as a matter of policy. Some lenders will make them in Hawaii, but not in Florida.

A large institutional lender prefers to make fee mortgages, placing them in its investment portfolio with the knowledge that the loans are secured by liens that cannot be disturbed or wiped out. This sense of security arises from the fact that the land will always be there and the lien of the mortgage, barring statutes of limitation, can be removed only through the affirmative act of the mortgagee. A mortgage lien on a leasehold, on the other hand, is a lien on an estate created by a lease. A lease can be terminated by means beyond the control of the mortgagee, thereby destroying the lien of the mortgage, unless the lease has been carefully drawn to protect the rights of the mortgagee. Even with a lease that is considered satisfactory for mortgage purposes, a mortgagee must be prepared to correct defaults of the lessee borrower, advancing funds to do so when necessary, in order to prevent the lessor from cancelling the lease. A large institutional lender, with thousands of mortgage loans and billions of dollars invested in real estate, knows that protective systems designed to protect leasehold investments sometimes break down. For example, while the lender may be entitled to a written notice from the lessor of a default by its lessee

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13 The leasehold variant is a relatively recent development in the condominium field and experience with the concept has been limited. The inherent difference between a fee simple and a leasehold condominium is that the unit purchaser in the former acquires a fee simple interest in the land, whereas the unit purchaser in the latter case acquires an interest in a leasehold on a fee. While the leasehold arrangement has been very popular in Hawaii and Florida, condominium legislation in the majority of jurisdictions requires that a horizontal property regime be constructed on a fee simple estate. The New York statute, which formerly contained this restriction, N.Y. REAL PROP. LAW § 339-e(1) (McKinney 1968), was only recently amended to permit the construction of a condominium devoted exclusively to nonresidential purposes on land held under a lease or sublease. In such case, the unexpired term or terms of the lease on the date of the recording of the declaration may not be less than thirty years. N.Y. SSS. LAWS [1974], ch. 1056, § 1 (McKinney).

14 For example, the lease might include a subordination clause under which the leasehold mortgage would have priority over any mortgage on the fee. Another suggested provision is a statement to the effect that in the event of any default on the part of the tenant, the landlord will not only give notice to the tenant but also to the leasehold mortgagee and that the mortgagee shall have time to cure such default. For a more detailed discussion of various lease provisions which will protect the rights of the leasehold mortgagee, see P. ROHAN, 5 REAL ESTATE FINANCING § 7.08 (1974).

15 For example, The Equitable Life Assurance Society of the United States has in excess of $6 billion invested in real estate mortgages.
borrower, the possibility will remain that a notice of default may be handled incorrectly or fail to reach the right person or department to permit corrective action to be taken within permitted time periods.

Notwithstanding the additional risk entailed in leasehold financing mortgage money is available for leasehold condominiums, but in a lesser amount and at slightly higher interest rates than for fee condominiums, and sometimes with a shorter loan term.

The two locations where leasehold condominiums exist in great numbers are Hawaii and Florida. In Hawaii, the leasehold form has been traditional, with most of the land area being tied up in estates established by the early families — very often with restrictions on sale. The land owners are not associated with the condominium developers, and ground rental has been modest, usually six percent of the appraised value of the land. In Florida, on the other hand, the developer usually owns or controls the land and the lease is created between related corporations with very high ground rentals, substantially increasing the annual expense of the leasehold condominium. The usual claim of the Florida leasehold condominium developer is that he sells the condominium unit for less because there is no investment in land. In fact, however, there is very little difference in the sales prices of comparable Florida fee and leasehold condominiums. Purchasers, for the most part, are not fully informed as to the significant difference between the two, and while the purchasers of leasehold condominiums are aware that they are paying a ground rent, if the aggregate monthly charges can be accommodated within the purchasers' budgets, they apparently offer no objections — at least at the time of purchase.

In leasehold condominium projects, the developer obtains a master lease on the entire property which provides for unit leases. This is accomplished either by permitting the developer to make subleases to the unit purchasers, which become direct leases with the ground owner when the master lease terminates, or by the entry of the ground owner into a unit lease directly with each unit purchaser. A mortgagee of a leasehold unit will normally require that the lease contain the following provisions:

(1) That the unit owner's obligations are limited to the payment of the ground rent and performance of the other lease covenants applicable to his unit only, so that defaults of other unit lessees will have no effect on the leasehold;

(2) That the lessee has the right to mortgage the leasehold;

(3) That the mortgagee shall be notified by the lessor of lessee's
defaults, with the mortgagee having the right to cure defaults during a period longer than that granted to the lessee;

(4) That, in the event of defaults which cannot be cured by the payment of money, the lessor shall not cancel the lease for the period of time required by the mortgagee to diligently pursue a foreclosure proceeding;

(5) Notwithstanding the foregoing, that in the event the lease is cancelled for any reason, the mortgagee, upon curing all monetary defaults, shall be entitled to a new lease of the unit for the balance of the lease term on the same terms and conditions as the original lease;

(6) That a mortgagee acquiring a unit by foreclosure, or conveyance in lieu of foreclosure, shall be able to assign the lease without restrictions, i.e., without having to obtain the lessor's approval of the assignee, although most mortgagees will not object to permitting the association of unit owners to have a first right to purchase by meeting the terms of a purchase offer received by the mortgagee; and

(7) That condemnation and fire insurance proceeds applicable to the improvements be paid to a trustee or to the association of unit owners, in trust, and be made available for restoration of the improvements.

By custom, ground leases in Hawaii provide that any condemnation award for land shall be paid to the ground lessor, and only the portion of a condemnation award for the taking of improvements shall be available to the condominium project for restoration of the remaining improvements. In the event the improvements are not restored, that portion of the award is to be distributed among the unit owners and their mortgagees. Such leases also provide that, in the event the condominium owners decide not to restore the project after a substantial casualty loss, the insurance proceeds shall be divided between the ground owners and the unit lessees. The ground owner would be entitled to an amount determined by a fraction, the numerator of which shall be the number of years of the term of the lease that have expired, and the denominator of which shall be the term of the lease, with the balance being allocated among the unit owners and their mortgagees.

Since Hawaiian condominium leases are usually for terms of from 51 to 75 years, these provisions relating to insurance proceeds have not seriously reduced the availability of mortgage funds other than to moderately reduce appraised values. Mortgages ordinarily are limited to 20 and 25 year terms on an amortizing basis. Mortgagees have apparently concluded that the amount of fire insurance proceeds remaining
and allocated to each unit will be adequate to at least pay in full the balance of the mortgage debt on each unit in the early years of the term. This confidence exists notwithstanding the sharing by the lessor in such proceeds in the event the condominium is not rebuilt. This provision will, however, prove to be a serious handicap to financing as the remaining term of the lease gets shorter and the lessor's share of insurance loss proceeds becomes larger.

It is interesting to note that a bill was proposed in the Hawaii Legislature that would have authorized the Hawaii Housing Authority to acquire, by eminent domain or purchase under threat of eminent domain, residential condominiums occupied by lessees.16 Under the bill, the acquisition could have been made upon a finding by the Authority that the lessees of more than sixty percent of the units in the project desired to own the leased fee interest to their units, and had the financial ability to pay for the same. After acquisition of the fee interest by the Authority, the lessee of a residential unit would have an option to purchase from the Authority, at any time during the term of his lease, the leased fee interest to his unit. The proposed bill contained a statement that the Legislature declared as a matter of legislative determination that the acquisition by a large number of people of residential units in fee simple promotes the public interest, health, welfare, security, and happiness. The legislation further stated that providing for the right of individuals to purchase the fee simple title to residential leasehold units is for a public purpose, and that the use of the power of eminent domain to condemn leasehold residential units for the purpose of making the fee simple title thereto and the use thereof available to the people of the state, is also in the public interest. The bill has since been vetoed by the Governor of Hawaii. Legislation has already been enacted which provides for the purchase of the fee simple title of single-family residential lots by lessees or the state.17

PHASE DEVELOPMENT OF CONDOMINIUMS

The construction of large-scale condominium projects in phases, rather than as an entirety, has many advantages and is a method acceptable to and, to some extent, encouraged by lenders. The first stage becomes the proving ground for, among other things, market testing and construction costs. Furthermore, it serves to keep a developer and

17 HAW. REV. STAT. §§ 516-21 to -44 (1968).
a lender from over-committing until there is some indication of feasibility and public acceptance of the project.

There have been differences of opinion among attorneys as to the method to be followed in drafting the declaration and other documents for a phased condominium. One view would favor a single condominium, with each phase being added to the condominium as it is completed and successive reallocations of the percentage interest of each unit owner in the common elements; that is, a smaller percentage in a larger area. The other view would argue that once a certain interest is vested in a unit owner, his percentage of interest in the common elements cannot thereafter be changed without his joining in a deed conveying away the part of his interest affected by any reallocation, and, further, would favor establishment of separate condominiums in each phase.

Lenders have generally been willing to accept either method if permitted by the applicable state statute. If the add-on method is used, however, the lender will insist that the condominium documents establish the complete plan for the entire project, including the time element involved. The plan must also provide for the exact reallocation of each unit owner's percentage interest in the common elements as new phases are developed and added. Lenders require that the value of the unit owner's interest in the common elements be substantially the same after each phase is added.

20 Only a handful of states specifically sanction the expandable condominium approach, and the developer usually proceeds pursuant to expansion rights contained in the declaration and bylaws, coupled with a written power of attorney from each of the initial unit purchasers. In New York, the Attorney General’s office will accept this procedure, provided the developer finalizes the number of units in the project (and their respective undivided interest), prior to closing of title to the first unit. Moreover, many title companies will not insure unit titles in a project wherein the developer has a right to build an indeterminate number of units or a right to add units over several future years.

The recently enacted Virginia condominium statute specifically sanctions not only the expandable condominium but also one that is “contractable,” i.e., one in which the developer may commit an entire parcel to the condominium project, reserving the right to withdraw any portion of the property that is not eventually used for units. VA. Code Ann. tit. 55, ch. 4.2, § 55-79.39 et seq. (Supp. 1974). The contraction procedure, however, is fraught with danger since a failure to follow necessary procedures to the letter (which procedures are not spelled out in any great detail) could lead to permanent loss of the unused portion of the property to the condominium. See id. § 55-79.64. By contrast, if a developer failed in his attempt to expand a single condominium by adding land to it, he would still be able to establish a second, parallel condominium.

For a thorough discussion of the legal problems involved and the mechanics employed by developers in constructing an expandable condominium, see 1 Rohan & Reskin § 16.03[2] (1974). For a complete set of documents and an offering plan for such a project, see 1A Rohan & Reskin App. C-8 (Wellesley Green Condominium).
CONDOMINIUM FINANCING

If the add-on phase development method is used, it raises no particular problem in handling a common recreation area that is intended for the use and benefit of the unit owners in all of the phases. Ordinarily, it becomes a part of the common elements of the first phase and of each phase added thereafter, and the reallocation of percentage interest takes care of it.

If separate condominiums are created for each phase, however, a more involved procedure is required to establish the interest of each unit owner since title to the recreation area is usually held by a separate entity. The most common practice is to either vest title to the recreation area in a trustee and make each unit owner a beneficiary under the trust, or to vest such title in an unincorporated association with each unit owner having a membership interest. The beneficial interest under the trust or the membership interest in the association, rather than the recreation area itself, becomes a part of the general common elements.

One of the problems of the lender in phased developments is the handling of the recreational elements during the early stages of the project. The problem is best illustrated by an example. Assume a project to be developed in five phases, with one separate recreation tract to serve all five. The condominium documents or the advertising states that this tract will contain a swimming pool, a clubhouse, and other recreational facilities. The unit lender will require that all the described facilities be constructed and paid for before the unit loans are closed in the first phase. In requiring this, however, the lender is painfully aware that in the event the planned future phases are not constructed, the unit owners of the first phase may be burdened with an excessive assessment to maintain the recreational facilities. If only the first phase is completed, the recreation area becomes an over-improvement and the original projected cost of maintenance allocated to the first phase may be multiplied fivefold.

One of the methods of avoiding this situation which has been acceptable to lenders has been to provide in the condominium documentation that the recreational facilities will be constructed as phases are completed; i.e., a swimming pool to be completed with the first phase, tennis courts with the second phase, a clubhouse with the third phase, and so forth. Provided the lender can properly appraise the value of the units for loan purposes, this method raises no financing problems and it keeps maintenance costs reasonably in proportion to the size of the project as finally completed. Nevertheless, some developers resist this method on the ground that it weakens the sales program, in that it may create doubt in the mind of a prospective purchaser.
that the project will be fully completed. Of course, purchasers of units must be fully informed of the developer's obligation with regard to future phases and additional recreational facilities.

**Casualty Insurance**

Mortgage lenders have traditionally required that, in the event of damage to the security due to fire or the perils protected against by extended coverage insurance, the insurance proceeds be paid to the mortgagee. At the option of the mortgagee, the proceeds may be applied in reduction of the mortgage indebtedness or in restoration of the damage. In financing condominiums, mortgagees have had to forego this option since the exercise of an option to apply loss proceeds allocated to a particular unit, in reduction of the loan secured by that unit, would leave insufficient proceeds available to the other unit owners to restore the damage. Lenders now insist that, notwithstanding the attachment of a mortgagee clause to the blanket policy, all insurance loss proceeds be payable to either an insurance trustee for the benefit of all unit owners or to the association of unit owners in trust. The proceeds would then be available either for restoration of the damage or, in the event the damage is not to be restored, for distribution on an allocated basis to the unit owners and their mortgagees in the same percentages as the common elements are allocated in the condominium declaration. A mortgagee will also require that a unit owner purchasing additional insurance on his own unit assign the proceeds of such insurance to the mortgagee. The rationale for this requirement is that such separate additional policies, if intended to cover insurable real estate fixtures, could result in the apportionment of loss between the company carrying the blanket policy on the entire property and the company carrying the policy on the individual unit. Therefore, to avoid any dispute developing between insurance carriers, the lender should require that any separate insurance carried by individual unit owners be placed with the same carrier as the blanket policy on the entire project, or that such improvements be included in the blanket policy with the added cost paid by the unit owner.

In examining the casualty insurance provisions, a mortgagee looks for assurance that there will be adequate insurance proceeds to restore the casualty loss or, if the unit owners decide to terminate the condominium, that the aggregate of the insurance proceeds allocated to the unit plus the unit owner's share in the proceeds of the sale of the remaining common elements, will be adequate to pay off the mortgage indebtedness. A mortgagee will be interested, therefore, in examin-
ing the basis for allocation among the units of their respective shares of available funds after a casualty loss coupled with a decision not to restore the damage. If the allocation is based on the unit owner's percentage interest in the common elements, computed on the basis of the initial sales price of each unit, it will probably result in a distribution satisfactory to a mortgagee, since mortgage amounts will usually be a percentage of sales price or appraised value. If, on the other hand, the unit owner's percentage interest in the common elements was based on the square-footage of the respective units, it could result in an unfair distribution of the available funds since the sales price or appraised value of units of the same size in a project may vary widely. A corner unit, with an attractive view, on the twenty-fifth floor of a high-rise project may sell for substantially more than an inside unit on the second or third floor of the same project.

**ECOLOGICAL CONSIDERATIONS**

The recent emphasis on evaluation of the environmental effects of large condominium projects has had a somewhat unsettling effect on construction lending. Land development always affects the environment to some extent, and determining if the beneficial effects outweigh the detrimental effects is not always a simple matter. The lender's fear is that, notwithstanding its own conclusion that a project will not adversely affect the environment to a serious degree, one or more environmentalist groups may bring an action to stop a project at some point during its construction. Even if the sponsor of the project and the mortgagee are successful in rebutting the claims of the plaintiffs in such an action, construction may be halted for an extended period of time, thus creating serious problems for both the sponsor and lender. If the court finds for the plaintiffs and orders a partially completed project removed, it could be disastrous.

While not a condominium project, the Tellico Dam, a $69 million project of the Tennessee Valley Authority (TVA) on the Tennessee River near Knoxville, illustrates the problem. A lawsuit to enjoin the construction was filed in late 1971 by three environmentalist groups and an interested property owner after the dam was partially completed and $35 million had been spent. Work was stopped until October, 1973, when a federal district court ruled that T.V.A.'s environ-

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21 The suit was brought by three nonprofit organizations—Environmental Defense Fund, Trout Unlimited, the Association for the Preservation of the Little T—and an individual landowner. Environmental Defense Fund v. Tennessee Valley Authority, 399 F. Supp. 806 (E.D. Tenn.), aff'd, 468 F.2d 1164 (6th Cir. 1972), application for stay denied, 414 U.S. 1036 (1973).
mental impact statement on the project met the requirements of the National Environmental Policy Act and that the project could proceed. A similar action against a large condominium project could increase the expense of the project to the point where it might be economically unfeasible to complete construction, since weather damage to exposed uncompleted structures, interest expense during a long delay, increased costs of building materials, and obtaining the return of the original contractor and subcontractors to the job, could prove enormously expensive.

The unsettled nature of state laws dealing with the environment contributes to the problem, since in most cases there are no absolutes in measuring adverse effects. California has attempted to meet the problem with the California Environmental Quality Act. The Act details a broad policy position for the state and requires a public agency approving a project to prepare, or require preparation of, an environmental impact report at the expense of the person proposing the project. The report is then made available to the public. There is a thirty day limitations period on actions to set aside the determination of the public agency approving a project and in the event the public agency makes no such determination, an action opposing a project must be brought within 180 days after the project is either approved or construction is commenced. Until similar procedures are established in other states, lenders will proceed with a great deal of caution in financing large condominium projects.

SEC Regulations and Full Disclosure Requirements

A full discussion of the impact of SEC regulations and of the Interstate Land Sales Full Disclosure Act on condominium financing in general is not possible within the limitations of this article. Lenders, in reviewing proposed condominium documents, may be able to determine, insofar as the documents are concerned, if the marketing of the units involves the offering of a security in the form of an investment contract, or participation in a profit-sharing agreement within the

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25 Id. § 21167(b).
26 Id. § 21167(a). Construction of a condominium project was delayed at the behest of concerned citizens in Friends of Mammoth v. Board of Supervisors, 8 Cal. 3d 247, 502 P.2d 1049, 104 Cal. Rptr. 761 (1972), because a local planning agency failed to prepare a report considering the possible adverse environmental impact.
27 See notes 9 & 11 supra.
meaning of the Securities Act of 1933\textsuperscript{29} and the Securities Exchange Act of 1934.\textsuperscript{30} In light of recent SEC interpretations, a cursory examination will no longer be sufficient; the mere advertising for sale may trigger SEC registration requirements.\textsuperscript{31} Institutional lenders will usually not participate in a condominium subject to SEC regulation, including the sale of units by salesmen registered as brokers or dealers under the 1934 Act, unless the developer clearly demonstrates compliance with the regulations. Completed condominiums, almost without exception, are delivered in less than two years after the contract of sale has been signed, thus exempting such projects from the Interstate Land Sales Full Disclosure Act.\textsuperscript{32}

**Other Types of Condominiums**

From both the developer's and the unit owner's viewpoint, the condominium form of ownership may be attractive for shopping centers, medical buildings and combination residential-commercial projects. Institutional lenders have been financing commercial units in combination residential-commercial projects, usually with a requirement that the unit or units be leased to substantial tenants or, if owner-occupied, that the borrowers have approved credit ratings. If a unit is leased, the lender ordinarily requires the assignment of the lessor's interest in the lease as collateral security for the loan. Since condominium shopping centers and condominium medical office buildings are subject to the same lending approach, undoubtedly institutional financing will be available for such projects provided the individual loans are of sufficient size to be of interest to the larger lenders.

A few industrial condominiums in multiple-unit structures have been successfully merchandised, but the financing in whole or in part was furnished by governmental agencies. If industrial condominiums prove successful on a larger scale, it is reasonable to anticipate that institutional lenders will find them attractive as investments. This will certainly be true of single-occupancy buildings in industrial parks.

The larger institutional lenders have displayed little interest in the financing of resort and "time-shared" condominiums.\textsuperscript{33} Adequate

\textsuperscript{30}Id. §§ 78a-jj (1970).
\textsuperscript{31}See note 9 supra.
\textsuperscript{33}In a time-sharing condominium, the purchaser receives title, as a tenant in common, to a particular unit and an undivided percentage interest in the common areas for a specific period of time within each year. Under this form of multiple ownership, a single unit will have a number of owners, each of whom will have the use and enjoyment of the condominium at a different time during the year. See Liebman, *Can Condominium Time-Sharing Work?*, 3 REAL ESTATE REV., Fall 1973, at 40.
financing for such units, usually in modest amounts, seems to be available to credit-worthy borrowers from banks and local savings and loan institutions.

CONCLUSION

The lending policies of institutional mortgagees are not subject to radical changes, but they are reasonably flexible and can adapt to innovations in real estate practices. The concern of the institutional lender, when requested to finance a condominium, whether on a construction or permanent unit basis, is first, to determine the ability of the borrower to repay the loan, and second, to determine the salvage value of the security if the borrower defaults. The institutional lender always appraises the real estate security as though every borrower will default and the indebtedness will have to be recovered through a foreclosure and sale of the security. It was for this reason that institutional lenders were reasonably cautious in their approach to residential condominium lending. They wanted assurances not only that the newly completed units would sell, but that a secondary market for the resale of units would develop.

In the early years of condominiums, it would have taken a brash prophet to predict that condominium unit ownership would develop as it has. In some sections of the country, construction of apartment condominiums exceeds the construction of conventional apartment buildings. A continuing demand has created a secondary market that has resulted in substantial increases in the resale prices of residential units. When it became apparent that residential condominiums were adequate and reliable as security for mortgage lending, institutional lenders were quick to make substantial funds available for condominium financing. It can be safely assumed that the same pattern will be followed in the financing of commercial and industrial condominiums. If initial acceptance and a resale market develops, as it did in the case of residential condominiums, institutional lenders will respond with reasonable promptness to make adequate financing available.