Leasing Restrictions in Condominiums

By Stephen Guerra

Investors have long viewed attached condominium units as ideal rental properties since the condominium form of ownership often allows investors to enter the rental business without taking on many traditional landlord functions. That is, because condominium associations are typically required to engage in the maintenance and repair of what otherwise would be a landlord duty in a non-condominium setting, it is simple for an investor to free themselves from many of the headaches associated with single-family rentals.

The last several years have seen falling home prices and an extremely tight lending environment. While those conditions frequently deterred or effectively prohibited owner-occupied unit sales, the conditions were ripe for investors with cash to deploy. Because of this, many condominium communities experienced unprecedented increases in the number of tenant-occupied and investor-owned units in their communities. While lending conditions are loosening and condominium unit prices appear to be on the rise, these favorable conditions do not change the reality that the number of tenant-occupied and investor-owned units in certain communities is approaching or perhaps exceeding levels permitted by both conventional and FHA-insured lenders.

In an effort to help ensure that their communities stay or eventually fall within lending underwriting requirements, many associations are taking the proactive step of amending their condominium documents to restrict the leasing of units in the community. While these restrictions come in various forms, they all attempt to deter or result in the deterrence of unit purchases for rental purposes. Prior to adopting such restrictions, however, communities must ensure that the restrictions do not impose undue hardships on current co-owners or do not otherwise violate the underwriting requirements of the institutions that these communities were attempting to comply with in the first place.

I. Legal Authority and Statutory Safeguards

Before discussing specific types of restrictions that address unit rentals, some preliminary points require emphasis. First, regardless of the language contained in a particular community's governing documents, all condominium communities benefit from, and are subject to, the provisions of Section 112 of the Michigan Condominium Act. Section 112 not only provides the statutory authority to restrict leasing, but it also sets forth provisions that allow the association to monitor leasing transactions and address more behavioral and financial-type issues relating to tenants and tenant-occupied units.

Section 112 requires any co-owner desiring to lease out a unit to disclose that fact in writing to the association at least 10 days before presenting a lease or otherwise agreeing to grant possession of a unit to a tenant, and to supply the association with an exact copy of the lease form to be used to enable the association to confirm that it complies with the community's governing documents and the Condominium Act. Once executed, the co-owner must provide the Association with a copy of the executed lease. If the co-owner is not utilizing a lease, the co-owner is required to supply the Association with the name and address of the lessee along with

the rental amount and due dates of any rental or compensation payable to the co-owner, the due dates of the compensation, and the term of the proposed arrangement.

Section 112 further requires that tenants comply with all of the conditions of the community's condominium documents, and requires that all leases explicitly state this requirement. This Section also provides specific remedies whenever a tenant fails to comply with the terms of the condominium documents, and also permits an association to collect rents directly from a tenant when the co-owner is delinquent in the payment of assessments.

While the referenced Section 112 provisions provide an association with "teeth" to monitor and control behavioral and financial aspects of unit rentals, Section 112 does not set forth any specific limitations on the number of units that may be rented in a given community. Rather, Section 112 merely provides the association with the general authority to amend its documents to control rentals or terms of occupancy.

II. Rationale for Enacting Leasing Restrictions, Types of Leasing Restrictions and the Procedure for Enactment

Various rationales are set forth for limiting the number of rental units in a given condominium community. Most often proffered is that tenants generally do not take as great an interest in the community as do co-owners, resulting in less incentive to keep up the property and greater apathy in becoming involved in the administration of the condominium. Beyond such theoretical considerations, however, and of even greater concern, is the fact that conventional lenders, the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), the Federal Housing Administration (FHA) and the U.S. Department of Veterans Affairs (VA) all have owner-occupancy and investor-owned requirements that govern their willingness to underwrite loans within a condominium community. Under current guidelines, Fannie Mae, Freddie Mac, the FHA and the VA will not make a new loan or refinance an existing loan in a condominium community unless at least 50% of the units are owner-occupied. Conventional lenders typically have even more stringent requirements, requiring in many instances that owner-occupancy levels be at 70% or even 80%, although conventional lenders may be flexible depending on the lender and the financial condition of the particular community. Fannie Mae, Freddie Mac, the FHA and the VA will also not make a new loan or refinance an existing loan in a condominium community if any investor owns more than 10% of the units in the community. Given the necessity of financing, no community can afford to be cut off from such financing.

There are a number of ways to limit the amount of rental units in a condominium. For instance, there can be a total ban on future rentals or a limit on rentals based on a percentage of the total units (e.g. only 10% of units may be leased at any given time). There can also be requirements for residency in a unit for a qualifying period before it can be rented as well as limitations relating to the number of units that may be rented by any individual at a given time (e.g. the Association will only approve a rental if (i) the Unit has not been occupied as the Co-owner's residence for a minimum period of at least one year immediately preceding the lease, or (ii) the leasing of such unit would result in any one person or entity leasing more than one Unit at any time). Any number of these provisions, or a combination of them, would go a long way toward restricting rentals in the future and ensuring that owner-occupancy and investor-ownership are at levels sufficient to meet mortgage underwriting requirements.

In determining what type of rental limit restriction to put in place, communities must keep in mind that certain rental restrictions may themselves violate lending underwriting requirements even though the intent of the restriction may be to keep owner-occupancy and investor-ownership at acceptable levels. For instance, while the FHA permits rental caps (e.g. a limit on rentals based on a percentage of total units in the community), the FHA will not certify a community or otherwise insure a unit loan if there is a total ban on leasing or if there are restrictions that require a timeframe for residency prior to an owner being able to lease. Likewise, the VA will not underwrite a loan with any rental limitations unless there is specific language exempting the VA from such limitations.

Communities must also be aware that extraordinary circumstances or emergencies can arise, such as long-term hospitalization, reassignment of employment or military deployment, which could be a hardship on co-owners who otherwise must comply with any enacted rental restriction. Therefore, communities should consider including hardship exceptions to any rental restriction so that those co-owners currently occupying their units are not penalized as a result of circumstances perhaps beyond their control.

To enact a leasing restriction, the community must obtain the approval of two-thirds of all co-owners entitled to vote, the approval of the developer if transitional control has not yet occurred, and the approval of two-thirds of those lenders holding a first mortgage of record. Lenders have ninety days to review and approve any proposed amendment and any lender who fails to vote against a proposed amendment is deemed to have approved it once the ninety day voting opportunity expires. Further, Section 112 mandates that any co-owner renting their unit under an approved lease prior to the enactment of a leasing restriction be “grandfathered-in” so that the co-owner’s right to lease to that tenant is not affected.

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Rental issues can be complex and the need to restrict and the type of restriction will vary as each association’s circumstances and goals are unique. Finding the best solution depends first on ensuring that the association has proper procedures in place to monitor leasing transactions and to otherwise know the level of owner-occupancy and investor-ownership in their communities. It then is incumbent upon the community to determine what type of leasing restriction will best fit their community, taking into consideration, among other things, the effect that any restriction may on a co-owner’s ability to obtain financing.