

2010 SUMMER CONFERENCE
REAL PROPERTY LAW SECTION
STATE BAR OF MICHIGAN

TROUBLED CONDOMINIUM PROJECT

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I. Introduction - Economy - Enough Said

II. Developer Insolvencies and Walk Aways

A. Restructuring the configuration of the project before and after foreclosure: Possible options under the Michigan Condominium Act (MCL 559.101) (“Act”). Enables flexibility for the reconfiguration of existing projects.

(1) Withdrawal of land/units (MCL 559.133): Must be reserved in the Master Deed; expires six years from the date of recording of the Master Deed. Condominium Act was amended in 2002 to extend the date by which a project may be contracted:

“Notwithstanding section 33, if the developer has not completed development and construction of units or improvements in the condominium project that are identified as “need not be built” during a period ending 10 years after the date of commencement of construction by the developer of the project, the developer, its successors, or assigns have the right to withdraw from the project all undeveloped portions of the project not identified as “must be built” without the prior consent of any co-owners, mortgagees of units in the project, or any other party having an interest in the project. If the master deed contains provisions permitting the expansion, contraction, or rights of convertibility of units or common elements in the condominium project, then the time period is 6 years after the date the developer exercised its rights with respect to either expansion, contraction, or rights of convertibility, whichever right was exercised last. The undeveloped portions of the project withdrawn shall also automatically be granted easements for utility and access purposes through the condominium project for the benefit of the undeveloped portions of the project. If the developer does not withdraw the undeveloped portions of the project from the project before expiration of the time periods, those undeveloped lands shall remain part of the

project as general common elements and all rights to construct units upon that land shall cease. In such an event, if it becomes necessary to adjust percentages of value as a result of fewer units existing, a co-owner or the association of co-owners may bring an action to require revisions to the percentages of value under section 95.” (MCL 559.167(3))

(2) Convertibility (MCL 559.131): Must be reserved in the Master Deed; expires six years from the date of recording of the Master Deed.

(3) Expandability (MCL 559.132): Must be reserved in the Master Deed; expires six years from the date of recording of the Master Deed.

(4) Subdivision/Consolidation/Modification (MCL 559.149): Modifying floor plans to incorporate a product that responds to changes in the market.

(5) Assignment of Developer Rights: If the lender is to pick-up from where the developer stopped and the developer has reserved in the Master Deed some or all of the rights described in (1) through (4) above, those rights need to be assigned to the lender so that the lender has the same flexibility. The problem for the lender, however, is that it may find itself taking on successor developer liabilities. See discussion below about how to minimize successor developer liabilities.

Assignment of developer’s rights does not make the assignee a successor developer. (MCL 559.235)

Without such a reservation and assignment, the amendment procedures under MCL 559.190 will need to be followed and existing co-owners will need to be involved in order to restructure the project.

(6) Easement Issues:

(a) When exercising flexibility rights, easements may need to be created. Easements can be created either in the Master Deed or in separately recorded document(s). Easements need to contain the following:

(i) A description of the permitted use(s).

(ii) If less than all co-owners are entitled to use the easement, a statement of the relevant restrictions on the easement’s use.

(iii) A statement of the rights of any others (not in the condominium) to use the same easement and a statement of the obligations, if any, of all persons required to contribute to the financial support of the easement. (MCL 559.135)

(b) Easements for land described as proposed future

development or land that has been withdrawn; can have easements that benefit the land not within the condominium boundaries.

(c) Rights of developer reserved in the Master Deed to grant easements needs to be assigned to the lender or deed in lieu grantee.

(d) Assignment of developer's easement rights:

“Subject to any restrictions the condominium documents may specify, the developer has a transferable easement over and on the common elements for the purpose of making improvements on the submitted land and any additional land pursuant to the provisions of those documents and of this act, and for the purpose of doing all things reasonably necessary and proper in connection therewith.”
(MCL 559.144)

B. Appointment of Receiver:

(1) Court Order: The lender has the option of requesting a court to appoint a receiver with the power to operate the project and sell units. (MCL 600.2927) If the lender is successful and the order appointing the receiver is entered, then the receiver takes possession of the property, i.e., the real and personal property constituting the condominium project, and proceeds to operate the project. Receiver can only act in accordance with and subject to the specific authority set out in the court order appointing the receiver. Because the lender has not foreclosed its mortgage at the time the receiver is appointed, there is no delay in turning over possession to the receiver who can immediately work towards preserving the developer's assets, marketing and/or leasing units, and completing construction of the development without the lender taking title to the mortgaged property.

(2) Developer's Rights: All rights of developer under the condominium master deed and under the Act need to be included in the order if the goal is for the receiver to continue with completion of the condominium development and the sale of condominium units owned by the developer. This means the developer also needs to agree in the order appointing the receiver to turn-over to the receiver all of the developer's records dealing with construction and management of the development. Unfulfilled purchase agreements and monies received under these agreements need to be delivered to the receiver as well. An assignment of the escrow account will also need to be set-up pursuant to MCL 559.183 and 559.184.

(3) Association: If the administration of the condominium association has not yet been turned-over to the condominium owners, all records and access to the association's funds need to be delivered to the receiver.

C. Successor Developer: (MCL 559.235)

(1) Definition: A person who acquires title to the lesser of 10 units or

75% of the units in a condominium project, other than a business condominium project, by foreclosure, deed in lieu of foreclosure, purchase, or similar transaction. (MCL 559.235(1))

(2) Business Condominium Exception: A successor developer that acquires title to the lesser of 10 business condominium units or 75% of the business condominium units in the condominium project shall not be required to assume, and shall not otherwise be liable for, any contractual obligations of its predecessor in title. (MCL 559.235(4))

(3) Residential Builder Exception: For projects established on and after May 9, 2002, a residential builder who neither constructs nor refurbishes common elements in a condominium project and who is not an affiliate of the developer, does not assume and is not liable for any contractual obligations of the developer, and shall not be considered a successor developer or acquire any additional developer obligations or rights in the absence of a specific assignment of those obligations or rights from the developer. However, a residential builder who sells a condominium unit is required to deliver to the purchaser of that condominium unit the condominium documents that the developer is required to deliver to purchasers under section 84a(1) of the Act.

(4) Multiple: Is possible to have multiple successor developers in a single project. Creates issues of allocation of liabilities and rights.

(5) Liabilities Assumed; Statutory Options for Minimizing Exposure: A successor developer is required to comply with both of the following:

(a) Comply with the Act in the same manner as a developer before selling any units.

(b) Assume all express written contractual warranty obligations for defects in workmanship and materials undertaken by its predecessor in title. A successor developer shall not be required to assume, and shall not otherwise be liable for, any other contractual obligations of its predecessor in title. (MCL 559.235(2)) Exception: A successor developer can be exempt from taking on liability for any express written contractual warranty obligations for defects in workmanship and materials, if either of the following is maintained with respect to units for which such a warranty was undertaken by the predecessor in title:

(i) Obtain an insurance policy, in a form approved by the insurance bureau, that is underwritten by an insurer authorized to do business in this state. The insurance policy must provide coverage for express written contractual warranty obligations for liability for defects in workmanship and materials.

(ii) Establish an aggregate escrow account with an escrow agent which contains not less than 0.5% of the sales price of each unit. If this escrow account is initiated by a successor

developer after acquisition of title, a total amount equal to 0.5% of the sales price of all units for which the warranty period plus 6 months has not expired shall be deposited by the successor developer in the aggregate escrow account, and 0.5% of the sales price of each unit shall be deposited by the successor developer in the aggregate escrow account periodically upon the sale of each remaining unit. The funds in this escrow account are not released until six months after the expiration of the warranty period for that unit. (MCL 559.235(3))

(6) Lender's Risks:

(a) Automatically a Successor Developer. If the mortgagee proceeds with foreclosure or otherwise takes title to the portion of the condominium development still owned by the developer in lieu of foreclosure, the mortgagee needs to be aware that it may also be taking on unintended obligations of the condominium developer. The potential liability that automatically arises as a successor developer needs to be weighed against the benefit of acquiring the developer's reserved rights under the condominium documentation.

Under the Michigan Condominium Act, developers (successor developers included), are required to comply with the following:

- In the sale of any individual units, a successor developer must use a purchase agreement that complies with the requirements of MCL 559.184(4).
- In the sale of any individual units, a developer must establish an escrow account and deposit all deposits received from prospective purchasers into such escrow account in accordance with the requirements of MCL 559.184(3).
- When selling any individual units, a developer must provide a Disclosure Statement (which must be updated and amended so that it is always current) and an association budget in accordance with the provisions of MCL 559.184(a) and 559.184(5). The Disclosure Statement will need, at a minimum, be amended to show the change in ownership and developer designation.
- If not already done, the non-developer members to the condominium association's board of directors will need to be selected by the co-owners in accordance with the timelines and requirements stated in MCL 559.152 (discussed later).
- Within one year of completion of construction of any condominium which is a phased project, a developer must prepare and record a Consolidating Master Deed and As Built Condominium Subdivision Plan as required by MCL 559.152(5).
- Under MCL 559.157, any developer while in control of an association must assure that that association has its financial statements independently reviewed on an annual basis.
- As of the "Transitional Control Date" (the date on which a majority of

the Board of Directors is elected by non-developer co-owners), the developer must fund any deficiency in the capital reserve fund which is less than 10% of the annual operating budget of the Association, pursuant to Rule 511 promulgated under the Michigan Condominium Act.

- The developer must complete development of the “must be built” items identified as such on the Condominium Subdivision Plan as well as those items that are designated must be built as a matter of law.

(b) Court Order-Limitations on Liabilities. If a court appointed receiver takes over completion of the condominium development, it is advisable to limit the lender’s and receiver’s liability by inserting a statement in the court order appointing the receiver, that the lender and receiver have no liability arising prior to the date of the order. The lender will also need to consider either taking out the insurance or establishing the statutory escrow account discussed above. Query: Can provisions in a receivership order override statutory obligations?

(c) Successor Developer without the Rights of the Developer. Much to the surprise of some lenders who have either foreclosed or taken a deed in lieu of foreclosure and who never obtained an assignment of the developer’s rights at the time the loan was taken out, have found themselves with limited development options. For example, the lender may be unable to withdraw unilaterally the undeveloped land from the project. Leaving the land in the project may not make sense economically depending on the market for the type of unit proposed for that land. Further, the lender may end-up with an obligation to the condominium association either for the association’s assessments or for the cost of expenses because the land is in the condominium. It is advisable that the assignment of developer rights not only apply in the event of a foreclosure of the mortgage, but also if the lender obtains title through a deed in lieu or other transfer.

(d) Obligations vis-à-vis Association. A further surprise often arises when a lender realizes that, not only is it assuming obligations for completion and sale of units and common elements, but also must now operate one or more associations, populate the board of directors of the association, create budgets and arrange for services (maintenance, repair, management, insurance and financial services), and also comply with requirements for transitioning the association board to non-developer co-owner control. These obligations can increase substantially in situations where the project is part of a planned unit development or involves control of a master association.

D. Warranty Performance:

(1) Developer Walk Aways/Lender Takes Over. Leaves purchasers without someone to fix warranty claims. Has the contractor signed a consent to

an assignment of the developer's contractor agreement and to provide warranties? Is the contractor obligated to continue to work?

(2) Subcontract Insolvencies. Leaves developer with limited resources to fix warranty claims.

(3) Homeowner Construction Lien Recovery Fund. The Homeowner Construction Lien Recovery Fund became insolvent last fall. HB 5830 amends the Construction Lien Act by abolishing and repealing provisions relating to the administration and funding of and disbursements from the Fund.

E. Must-Be-Built Commitment; Never Built:

(1) Improper Condominium Subdivision Plans with no designation of need not built improvements. Is the developer obligated to build the improvements?

"Any proposed structure and improvement shown shall be labeled either "must be built" or "need not be built". To the extent that a developer is contractually obligated to deliver utility conduits, buildings, sidewalks, driveways, landscaping and an access road, the same shall be shown and designated as "must be built", but the obligation to deliver such items exists whether or not they are so shown and designated." (MCL 559.66(2)(j))

"The developer shall complete all structures and improvements labeled pursuant to subsection (2)(j) "must be built". (MCL 559.66(4))

(2) Is there a successor obligation to complete?

(3) Are bonds or escrows established with the escrow agent?

" . . . [a]mounts required to be retained in escrow in connection with the purchase of a unit shall be released to the developer pursuant to subsection (6) only upon all of the following:

(a) Issuance of a certificate of occupancy for the unit, if required by local ordinance.

(b) Conveyance of legal or equitable title to the unit to the purchaser.

(c) Receipt by the escrow agent of a certificate signed by a licensed professional engineer or architect either confirming that those portions of the phase of the project in which the condominium unit is located and which on the condominium subdivision plan are labeled "must be built" are substantially complete, or determining the amount necessary for substantial completion thereof.

(d) Receipt by the escrow agent of a certificate signed by a licensed professional engineer or architect either confirming that recreational or other facilities which on the condominium subdivision plan are labeled "must be built", whether located within or outside of the phase of the project in which the condominium unit is located, and which are intended for common use, are substantially complete, or determining the amount necessary for substantial completion thereof." (MCL 559.201b(3))

Exception to funds being escrowed at closing:

"In place of retaining funds in escrow under subsection (3), the developer may, if the escrow agreement so provides, furnish an escrow agent with evidence of adequate security, including, without limitation, an irrevocable letter of credit, lending commitment, indemnification agreement, or other resource having a value, in the judgment of the escrow agent, of not less than the amount retained pursuant to subsection (3)." (MCL 559.201b(5))

(4) Are bonds or escrows established with the local municipality? Can they be accessed by the lender or the association?

F. Resale of portion of incomplete units: Bulk sale of units at a discounted price.

(1) Lender approval needed? Borrower consent needed if lender is effecting the sale?

(2) Will purchaser obtain an assignment of developer rights (versus developer's obligations)?

(3) Issues exist in foreclosure situations due to statutory bias in favor of sale of separate parcels. (MCL 600.3165).

G. Construction Completion Schedule-Outside Date:

(1) Section 67(3) of the Act. See discussion above.

(2) Proposed New Legislation. HB 5974. Introduced for the purpose of extending the date undeveloped property can no longer be developed by the developer from six to ten years. Not clear is how this bill impacts Section 67(3) of the Act.

H. FHA/FNMA Considerations:

(1) FHA. Mortgagee Letter 2009-46A dated November 6, 2009 (copy attached). This letter waives five of the permanent baseline requirements for condominium project eligibility set out in Mortgagee Letter 2009-46B dated November 6, 2009 (copy attached).

(a) Spot loan approvals eliminated as of February 1, 2010.

(b) Concentration of FHA loans in a development increased to 50%. Exception: can be 100% if project meets all of the basic condominium standards plus (does not apply to new construction or conversions): (i) project is 100% completed for at least one year; (ii) 100% of units have been sold and no entity owns more than 10% of the units; (iii) project budget provides for a minimum of 10% reserve; (iv) association control has transferred to the owners; and, (v) the owner-occupancy ratio is at least 50%.

(c) At least 50% of units owner occupied. This requirement is a problem in many projects due to the increased number of units being rented that are unable to be sold. Exception: Projects under construction or still in initial marketing period, minimum is 50% of the number of presold units. Bank owned and vacant units not factored in the calculation.

(d) Presale requirement. Temporary reduction from 50% to 30%.

(e) Relates to condominium projects located in Florida.

(2) FHA. Mortgagee Letter 2009-46B. Highlights of the permanent baseline requirements.

(a) Lenders have processing options.

(i) HUD Review and Approval Process (HRAP).

(ii) Direct Endorsement Lender Review and Approval Process (DELRAP). (Lender needs authority to process under this option.)

(b) Site condominiums-approval not required.

(c) Commercial space- cannot exceed 25% of the total floor area and not adverse to residential units.

(d) Investor owned units (including developer vacant and unsold units) limited to 10%. If 10 or less units in the project, limit is one unit.

(e) No more than 15% of total units in arrears (more than 30 days past due) of payment of their assessments.

(f) Association budget. Reserve of at least 10%. Reserve study may be needed if FHA budget requirements not met.

(g) Conversions. One year waiting period is eliminated.

(3) FNMA. Regulations require specific language in the condominium

documentation. Effective February 1, 2010, FNMA no longer accepts FHA approved condominium projects; rather, FNMA underwriting requirements must be satisfied.

I. Rentals:

(1) Number of investor owned units limits financing options. As indicated previously, the FHA and FNMA eligibility requirements are impacted by high rates of rentals (beyond 50%) or concentrations of investor owned units beyond 10%. In addition, several institutional lenders have their own underwriting guidelines that impact their decisions to lend in projects with rental concentrations as low as 30%. In this difficult sales market, you have an increased number of people renting their units to make ends meet in lieu of sale, yet that very survival technique can have the effect of making sales even less likely as both government backed and conventional loan approvals are less likely when rental percentages rise.

(2) Operation issues arise from tenants unwilling to follow development restrictions. Regulation of tenant behavior under the Condominium Act is governed by MCL 559.212. This involves a process of notification of the owner of the unit to obtain compliance, followed by eviction of the tenant if compliance is not forthcoming. Unfortunately, this process demands attention by an active association board, which is unlikely to be present in a defaulted project, both before and after a lender takeover. The fallout from inaction over a period of time includes a proliferation of various violations and claims of reliance and laches when and if the association gets to the point where it is in a position to address such things. Negative property value implications can also arise from inaction in addressing such violations, as can liability for the lender controlled board.

III. Impact on Associations

A. Governance - Percentage of units sold not at threshold for turnover. The Condominium Act requires that the Bylaws for a Project contain certain language mandating gradual population of the Board with non-developer Co-owners, eventually resulting in transition to Co-owner control. MCL 559.152 provides:

Sec. 52.

(1) An advisory committee of nondeveloper co-owners shall be established either 120 days after conveyance of legal or equitable title to nondeveloper co-owners of 1/3 of the units that may be created or 1 year after the initial conveyance of legal or equitable title to a nondeveloper co-owner of a unit in the project, whichever occurs first. The advisory committee shall meet with the condominium project board of directors for the purpose of facilitating communication and aiding the transition of control to the association of co-owners. The advisory committee shall cease to exist when a majority of the board of directors of the association of co-owners is elected by the nondeveloper co-owners.

(2) Not later than 120 days after conveyance of legal or equitable title to nondeveloper co-owners of 25% of the units that may be created, at least 1 director and not less than 25% of the board of directors of the

association of co-owners shall be elected by nondeveloper co-owners. Not later than 120 days after conveyance of legal or equitable title to nondeveloper co-owners of 50% of the units that may be created, not less than 33-1/3% of the board of directors shall be elected by nondeveloper co-owners. Not later than 120 days after conveyance of legal or equitable title to nondeveloper co-owners of 75% of the units that may be created, and before conveyance of 90% of such units, the nondeveloper co-owners shall elect all directors on the board, except that the developer shall have the right to designate at least 1 director as long as the developer owns and offers for sale at least 10% of the units in the project or as long as 10% of the units remain that may be created.

(3) Notwithstanding the formula provided in subsection (2), 54 months after the first conveyance of legal or equitable title to a nondeveloper co-owner of a unit in the project, if title to not less than 75% of the units that may be created has not been conveyed, the nondeveloper co-owners have the right to elect, as provided in the condominium documents, a number of members of the board of directors of the association of co-owners equal to the percentage of units they hold and the developer has the right to elect, as provided in the condominium documents, a number of members of the board equal to the percentage of units which are owned by the developer and for which all assessments are payable by the developer. This election may increase, but does not reduce, the minimum election and designation rights otherwise established in subsection (2). Application of this subsection does not require a change in the size of the board as determined in the condominium documents.

(4) If the calculation of the percentage of members of the board that the nondeveloper co-owners have the right to elect under subsection (2), or if the product of the number of members of the board multiplied by the percentage of units held by the nondeveloper co-owners under subsection (3) results in a right of nondeveloper co-owners to elect a fractional number of members of the board, then a fractional election right of 0.5 or greater shall be rounded up to the nearest whole number, which number shall be the number of members of the board that the nondeveloper co-owners have the right to elect. After application of the formula contained in this subsection, the developer has the right to elect the remaining members of the board. Application of this subsection does not eliminate the right of the developer to designate 1 member as provided in subsection (2).

(5) A consolidating master deed and plans showing the condominium as built shall be recorded not later than 1 year after completion of construction in order to consolidate all phases or amendments of a condominium project. A copy of the recorded consolidating master deed shall be provided to the association of co-owners.

(6) As used in this section, "units that may be created" means the maximum number of units in all phases of the condominium project as

stated in the master deed.

(7) For purposes of calculating the timing of events described in this section, conveyance by a developer to a residential builder, even though not an affiliate of the developer, is not considered a sale to a nondeveloper co-owner until such time as the residential builder conveys that unit with a completed residence on it or until it contains a completed residence which is occupied.

With the lack of attention devoted to the project by the developer prior to a lender taking over coupled with most lenders' continued inattention to this aspect of project administration, there is significant tension between the co-owners' desire to manage their neglected project and a lender's desire to maintain control while disposing of the asset as best as it can. Liability also looms for the lender that does not take these obligations seriously.

(1) Developer Board Members/Decisions Pending. Many lenders pay insufficient attention to their obligations to populate Boards with directors or to insure compliance with Section 52. Given what is usually a period of inattention to the project by the developer prior to the bank taking over, operational decisions such as budgeting, collection of past due accounts and contracting for project services may be seriously delinquent. Continued inattention by the lender can lead to liability for breach of fiduciary duty and can negatively affect the asset's already diminished value. While an appointed receiver can alleviate some of the pressure, little attention is normally paid to these obligations in the receivership order (by way of direct authority or authority to hire a competent manager) resulting in a continued, albeit unintentional, disregard of these important administrative issues.

(2) Early Turnover. Most condominium documents contain the section 52 provisions as required, but also do not restrict a developer from turning over control of an association at an earlier time. The lender must evaluate its ability to fulfill these obligations and the liability that may flow from not doing so and balance that against the true advantage of maintaining control. There is much that goes into such a decision, including financial obligations that flow from transition under administrative Rule 511, but it may actually be in the lender's best interest to transition the project sooner rather than later.

(3) Compelling Turnover. At the other end of the spectrum, the members of a neglected association may decide to take action to compel an early transition. If circumstances exist that amount to waste, the association members may be able to either convince a circuit judge to order transition or at least obtain the appointment of a receiver/manager to manage association operations, perhaps at the expense of the neglectful lender. These remedies, except lender liability, are also appropriate in situations where a developer has abandoned the project and a lender has yet to obtain title to the assets in question.

(4) More FHA/FNMA Implications. As with most operational issues, under the FHA and FNMA guidelines, the lack of attention to administration can impact the availability of financing for unit sales and refinance transactions. Both sets of

regulations require adequate budgets, including contributions to and keeping of an adequate reserve fund, in addition to certain document provision requirements by FNMA.

B. Collections

(1) Successor Developer Obligations. For the most part, the Condominium Bylaws control a developer's responsibility to pay assessments or a share of expenses to the association. It should be stressed that the lender will not have an obligation as successor developer to fund deficiencies in assessments accrued by its predecessor. It will, however, have an assessment obligation moving forward from the date of its foreclosure sale or deed in lieu. (Under the Condominium Act, assessments accrue from the date of title, not from the date of possession.) In a PUD or multiple association situation there may also be a separate assessment obligations to a community association which would be governed by the Declaration providing for the same. Regardless of the fact that a successor developer may have no obligation under the governing documents to pay assessments, the financial condition of the association will likely impact marketability of the acquired units and land. Business decisions will invariably have to be made with respect to dealing with these issues since accrued deficits will likely result in markedly increased assessment levels either temporarily or permanently and both situations will affect the willingness of third party purchasers to purchase units and consequently, the willingness of third party builders to purchase property that is intended for eventual sale to third party purchasers. It is also likely that these issues will also play a role in deciding whether and if undeveloped land and units should remain within the existing condominium or be removed for development as separate projects, if possible.

(2) More FHA/FNMA Implications. Given the requirement in both the FHA and FNMA guidelines that no more than 10% of the units may be more than 30 days delinquent, the failure of a successor developer to pay assessments and/or collect those due from existing co-owners can negatively affect the availability of financing for unit sales and refinance transactions.

C. Services-Adequate Budget-Increasing Assessments to cover existing and anticipated future foreclosures. As previously indicated, a successor developer will have fiduciary obligations to provide adequate services through the association and also to ensure that the budget is adequate and assessment levels sufficient to operate the project without deficits. In all likelihood dramatic revisions will be necessary to return the project to a financially stable condition, however, the advisability of substantially raising assessments will need to be balanced against the negative effect of high assessment levels on marketability and collection and a business decision may have to be made by the successor developer in favor of financial subsidies in the short term.

D. Official Records of Association Maintained. This is a little considered obligation that comes with responsibility for operating the association. Minutes of meetings must be kept, annual meetings must be held as required by the Condominium Documents, financial records must be kept and reviewed annually by an independent accountant and tax returns and MARs must be filed. Liability may arise from failure to fulfill these responsibilities.

E. All Capital Contributions Collected at Closings. Moreover, turned over to the Association? Be aware that in certain circumstances Condominium Documents contain the obligation to pay “working capital”, “insurance reserves” and “capital reserve” contributions, as opposed to such obligations being provided simply by purchase agreements. In such cases, such contributions must be made and can be compelled by an association.

F. Condominium Documents Consistently Enforced. One of the fundamental and primary obligations of an association is to enforce the Condominium Documents. Inattention to such obligations cannot only create problems for future administration and sales, it can lead to successor developer liability for breach of duty while controlling an association.

(1) Precedents. As pointed out above with respect to the discussion relating to tenants, failure to enforce can cause numerous problems. While a developer or successor developer (if such rights are assigned) usually has reserved rights stated in the Condominium Documents to grant variances and do certain things otherwise not allowed if done by non-developer co-owners, there can be repercussions for compromising material rights of the co-owners, neglecting pursuit and correction of violations and/or acting contrary to the provisions of Condominium Documents. Examples of such concerns include the changing of unit types and materials to an extent that negatively affects existing market values without clear rights to do so contained in the recorded Condominium Documents or contraction of a project in a manner not allowed by the recorded Condominium Documents.

(2) Lack of Enforcement - Changed Conditions. Generally, actions or permissions granted by a developer or successor developer do not prevent an association from enforcing restrictions after turnover to co-owner control, however, if the result of those actions and permissions is to change the character of the project to the extent that the restriction no longer is viable, it may be declared unenforceable by a court of competent jurisdiction. In severe situations, this may impact the value of units and lead to liability for the unsuspecting successor developer.

G. Developer Incentives to Entice Purchasers. In this difficult market, a successor developer may be tempted to provide incentives to entice purchasers. Most such incentives present no particular problem. The exception to this is incentives related to the payment of assessments. Particular attention must be given to the provisions of the Condominium Documents relating to the assessment obligation. Absent specific authorization in the documents allowing a developer to discount or excuse assessments in certain instances, most documents require assessments be paid according to the percentage of value for the unit in question applied against the total operating budget. Absent a developer or successor paying the difference in an assessment concession situation under normal document provisions, the association would have rights against both the unit purchaser and the developer or successor for collection of what should have been paid.

H. Warranty Claims- Developer Insolvent/Bankrupt/Non-existent Assignment. As pointed out in the discussions above, the insolvency of a developer coupled with the limited responsibilities of a successor developer can leave an association without

effective recourse for redress of warranty issues. This situation is further complicated by the association's lack of privity with the developer's subcontractors who may actually be responsible for the defective work. Beyond reliance on the benevolent actions of a successor, an association is well advised to seek an assignment of claims from the insolvent developer as against its subcontractors.

I. Construction Liens. Many project default situations involve unpaid contractors, suppliers and subcontractors and resolution of various construction liens. The resolution of such claims usually is the single most important factor in delaying the transfer of ownership, which in turn leads to many of administrative deficiencies and problems addressed above. While a comprehensive discussion of foreclosures and lien priorities is beyond the scope of this presentation, a cursory look at some of the main issues is in order.

(1) Improperly Placed on Units. The Condominium Act contains provisions governing the proper placement of construction liens in MCL 559.232. These provisions are repeated in the Construction Lien Act at MCL 570.1126.

“A construction lien otherwise arising under the construction lien act, 1980 PA 497, MCL 570.1101 to 570.1305, is subject to the following limitations:

(a) Except as provided in this section, a construction lien for work performed upon a condominium unit or upon a limited common element may attach only to the condominium unit upon which the work was performed or to which the limited common element is appurtenant.

(b) A construction lien for work authorized by the developer, residential builder, or principal contractor and performed upon the common elements may attach only to condominium units owned by the developer, residential builder, or principal contractor at the time of recording of the statement of account and lien.

(c) A construction lien for work authorized by the association of co-owners may attach to each condominium unit only to the proportionate extent that the co-owner of the condominium unit is required to contribute to the expenses of administration as provided by the condominium documents.

(d) A construction lien may not arise or attach to a condominium unit for work performed on the common elements not contracted by the developer, residential builder, or principal contractor or by the association of co-owners.” (MCL 559.232)

The most frequent issues encountered are liens on units no longer owned by the developer for work contracted by the developer in violation of subsection (b), liens on the entire project for work that was only performed on certain units or limited common elements in violation of subsection (a), the failure to apply liens separately to specific units and all units depending on where the work was performed (certain contractors perform work on both individual units and limited common elements as well as on the

general common elements and fail to attach liens separately as mandated by these provisions) and failure to partially release a lien when a specific unit tenders payment to the proportionate extent that the co-owner of the condominium unit is required to contribute to the expenses of administration as provided by the condominium documents. These issues normally require substantial time to sort out.

(2) Priority Issues. As condominium project takeovers and givebacks increase, so does construction lien enforcement proceedings associated with these projects. Priority issues abound between lenders and contractors related to the first actual physical improvement. Close behind, but usually with much less at stake, are priority issues between foreclosing lenders and the association and construction lien claimants and the association. The disputes are rooted in the statutory provisions that govern priorities. The Michigan Condominium Act of 1978 contains the following:

“(1) Sums assessed to a co-owner by the association of co-owners that are unpaid together with interest on such sums, collection and late charges, advances made by the association of co-owners for taxes or other liens to protect its lien, attorney fees, and fines in accordance with the condominium documents, constitute a lien upon the unit or units in the project owned by the co-owner at the time of the assessment before other liens except tax liens on the condominium unit in favor of any state or federal taxing authority and sums unpaid on a first mortgage of record, except that past due assessments that are evidenced by a notice of lien recorded as set forth in subsection (3) have priority over a first mortgage recorded subsequent to the recording of the notice of lien. ...” (MCL 559.208)

This provision is quite clear in resolving the dispute between the foreclosing lender and the association - a first recording lender has priority. On the other hand, issues between the association and contractors are a bit more problematic, given the following language in the Michigan Construction Lien Act of 1982:

“(3) A construction lien arising under this act shall take priority over all other interests, liens, or encumbrances which may attach to the building, structure, or improvement, or upon the real property on which the building, structure, or improvement is erected when the other interests, liens, or encumbrances are recorded subsequent to the first actual physical improvement.

(4) A mortgage, lien, encumbrance, or other interest recorded before the first actual physical improvement to real property shall have priority over a construction lien arising under this act.” (MCL 570.1119)

While there does not appear to be much question as to the priority of the association lien if it arises prior to the first actual physical improvement, contests have arisen as to when the lien is effective (upon recording the Master Deed or only when a lien is actually recorded?) and in situations where the first actual physical improvement takes place either before the recording of a Master Deed or the recording of an assessment lien. To the author’s knowledge these arguments have yet to be resolved by a reporting

court, however, in this author's opinion, the unequivocal language of section 108 to the effect that unpaid association assessments constitute a lien "before other liens except tax liens on the condominium unit in favor of any state or federal taxing authority and sums unpaid on a first mortgage of record" is pretty hard to overcome, especially when you consider that this language became law four years prior to the Construction Lien Act and while the legislature could have altered this specifically in the Construction Lien Act, it did not do so.

IV. Non-Payment of Property Taxes

A. Unexpected result is the taxing unit to be a successor developer under MCL 559.235. Practically, after the tax foreclosure process, warranty obligations may have expired.

B. MCL 559.67(3)—Units convert to general common element. What happens to the tax bills that covered the units prior to that conversion?

V. Developers/Lenders/Owners-Working Together to Find Solutions – Minimizing the Impact

ATTACHMENTS:

FHA Mortgagee Letter 2009-46A

FHA Mortgagee Letter 2009-46B



U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-8000

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

November 6, 2009

MORTGAGEE LETTER 2009-46 A

TO: ALL APPROVED MORTGAGEES

SUBJECT: Temporary Guidance for Condominium Policy

In Mortgagee Letter 2009-46 B, the Federal Housing Administration (FHA) announced the permanent baseline guidance for condominium project eligibility. This Mortgagee Letter (ML) waives five provisions of that guidance and serves as a temporary directive to address current housing market conditions. This temporary guidance is effective for all FHA case numbers assigned on or after December 7, 2009 through December 31, 2010, except as noted for the "Spot Loan" Approval Process. FHA reserves the right to modify, suspend or terminate the guidance contained in this document if analysis of condominium mortgage performance indicates that the insurance fund is at risk.

I. "Spot Loan" Approval Process

Mortgagee Letter 2009-46B eliminated the Spot Loan Approval Process as defined in Mortgagee Letter 1996-41 for all FHA case number assignments effective on or after December 7, 2009. However, to address concerns involving the volatility in the condominium market, the new effective date for the elimination of this practice is for all FHA case number assignments on or after February 1, 2010. FHA may perform additional monitoring to ensure compliance with the "Spot Loan" Approval Process.

II. FHA Concentration Requirements

The FHA concentration requirement defined in ML 2009-46 B will be increased temporarily to 50 percent.

Exceptions to 50 percent Concentration Level. The FHA concentration may be increased up to 100 percent if the project meets all of the basic condominium standards plus the additional items stated below:

- The project is 100 percent complete and construction has been completed for at least one year, as evidenced by issuance of the final or temporary/conditional certificate of occupancy for last unit conveyed;

- 100 percent of the units have been sold and no entity owns more than 10 percent of the units in the project (for projects with fewer than 10 units, single entity may own no more than 1 unit);
- The project's budget provides for the funding of replacement reserves for capital expenditures and deferred maintenance in an account representing at least 10% of the budget;
- Control of the Homeowners Association has transferred to the owners; *and*
- The owner-occupancy ratio is at least 50 percent.

Note: New construction and conversions are not eligible for this exception.

III. Owner-Occupancy Requirements

At least 50 percent of the units in a project must be owner-occupied or sold to owners who intend to occupy the units. For proposed, under construction, or projects still in their initial marketing period, FHA will allow a minimum owner occupancy amount equal to 50 percent of the number of presold units.

Vacant or tenant-occupied real estate owned (REOs), including properties that are bank owned, may be excluded from the calculation of the required owner-occupancy percentage (should be removed from both the numerator and denominator).

IV. Pre-Sale Requirements

In the case of new construction, the pre-sale requirement defined in ML 2009-46 B will be reduced temporarily to 30 percent. Per ML 2009-46 B, the pre-sale percentage must be documented as follows:

- Copies of sales agreements and evidence that a mortgagee is willing to make the loan;
- Evidence that units have closed and are occupied; **OR**
- Information from a developer/builder that lists all of the units already sold, under contract, or closed (e.g. a spreadsheet, chart, or listing used for the company's own tracking purposes) that is accompanied by a signed certification from the developer (Attachment F of ML 2009-46 B).

V. **Florida Condominium Project Approval**

All requests for approval of condominium projects located in Florida will require submission to the Atlanta Homeownership Center for review, under the HUD Review and Approval Process (HRAP). These projects are not eligible for approval using the Direct Endorsement Lender Review and Approval Process (DELRAP), defined in ML 2009-46 B.

If you have questions regarding this Mortgage Letter, please call the FHA's Resource Center at 1-800-CALLFHA (1-800-225-5342). Persons with hearing or speech impairments may access this number via TDD/TTY by calling 1-877-TDD-2HUD (1-877-833-2483).

Sincerely,

David H. Stevens
Assistant Secretary for Housing-
Federal Housing Commissioner



U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-8000

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

November 6, 2009

MORTGAGEE LETTER 2009-46 B

**TO: ALL APPROVED MORTGAGEES
ALL FHA ROSTER APPRAISERS**

SUBJECT: Condominium Approval Process for Single Family Housing

In accordance with the passage of the Housing and Economic Recovery Act of 2008 (HERA), the Federal Housing Administration (FHA) is implementing a new approval process for condominium projects and insurance requirements for mortgages on individual units, as authorized under Section 203(b) of the National Housing Act. The requirements of this Mortgagee Letter are effective for all case numbers assigned on or after December 7, 2009, except as noted. This Mortgagee Letter revises and consolidates existing guidance, and therefore replaces Mortgagee Letter 2009-19.

FHA will now allow lenders to determine project eligibility, review project documentation, and certify to compliance with Section 203(b) of the NHA and 24 CFR 203 of FHA's regulations. FHA will continue to maintain a list of approved condominium projects. Lenders will be required to retain all the project legal documents, contracts, conveyances, plats, plans, insurance coverage, presale and owner occupancy conditions and other documentation in connection with their review and approval of the condominium project.

PROJECT APPROVAL

I. Approval Processing Options

- A. Lenders will have two condominium project approval processing options. The applicable documentation requirements will be the same for each option:
1. HUD Review and Approval Process (HRAP).
 2. Direct Endorsement Lender Review and Approval Process (DELRAP), outlined in this Mortgagee Letter. This option is only available to lenders who have unconditional Direct Endorsement authority and staff with knowledge and expertise in reviewing and approving condominium projects.

Under DELRAP, lenders must provide the condominium approval or denial documents to FHA within five (5) business days of final disposition. These documents must be uploaded using *pdf* format through FHA Connection.

B. The processing options stated above will be applicable to condominium developments that are:

1. Proposed or Under Construction;
2. Existing Construction; or
3. Conversions.

C. Lenders who are eligible to and do process condominium approvals under DELRAP may exercise the option, at their discretion, to submit a condominium project for approval under the HRAP.

II. Eligible Projects

The Condominium Project has been declared and exists in full compliance with applicable State law requirements of the jurisdiction in which the condominium project is located, and with all other applicable laws and regulations.

III. Ineligible Projects

- A. Condominium Hotel or “*Condotels*”
- B. Timeshares or segmented ownership projects
- C. Houseboat projects
- D. Multi-dwelling unit condominiums [*i.e.* more than one dwelling per condominium unit]
- E. All projects not deemed to be used primarily as residential

IV. General Requirements

- A. Site Condominiums (effective June 12, 2009)

Condominium project approval is **not** required for Site Condominiums. Site Condominiums are defined as single family totally detached dwellings (no shared garages or any other attached buildings) encumbered by a declaration of condominium covenants or condominium form of ownership. Site Condominiums that do not meet this definition will require project approval. See Loan Approval section for processing and documentation requirements for unit financing of Site Condominiums.

- Manufactured Housing Condominium Projects (MHCPs) may **not** be treated as Site Condominiums; these projects require approval under HRAP.
- Modular homes are processed as single family homes for insurance purposes and are eligible to be treated as Site Condominiums as long as they meet the stated definition for site condominiums.

B. Environmental Review Requirements

If a lender elects to use the HRAP option, then environmental reviews will not be required for projects that, at the time that condominium project approval is requested, have progressed beyond a stage of construction where HUD has any influence over the remaining uncompleted construction. This occurs when:

- a condominium plat or similar development plan and any phases delineated therein have been reviewed and approved by the local jurisdiction and, if applicable, recorded in the land records, **and**
- the construction of the project's infrastructure (streets, stormwater management, water and sewage systems, utilities), and facilities (e.g., parking lots, community building, swimming pools, golf course, playground, etc.) and buildings containing the condominium units has proceeded to a point that precludes any major changes.

Environmental reviews will not be required for condominium projects approved using the DELRAP option. If the appraiser identifies an environmental condition or the lender is aware of an existing environmental condition through remarks provided on the Builder's Certification, Form HUD-92541, the appraisal or other known documentation, the lender must avoid or determine that there are mitigants to address the following conditions before completing its review process:

1. The project is located in a Special Flood Hazard Area designated on a Federal Emergency Management Agency flood map.
2. Potential noise issues, where the property is located within 1000 feet of a highway, freeway, or heavily traveled road, within 3000 feet of a railroad, or within one mile of an airport or five miles of a military airfield.
3. The property has an unobstructed view, or is located within 2000 feet, of any facility handling or storing explosive or fire-prone materials.
4. The property is located within 3000 feet of a dump or landfill, or of a site on an EPA Superfund (NPL) list or equivalent state list, or a Phase I Environmental Site Assessment indicates the presence of a Recognized Environmental Condition or recommends further (Phase II) assessment for the presence of contaminants that could affect the site.
5. The property has any hazards or adverse conditions listed in Section 1.f. of the Builder's Certification, including, but not limited to, high ground water levels, unstable soils, or earth fill.
6. The project is located in a wetland designated on National Wetlands Inventory maps or designated by State or local authorities.
7. The project is on the National Register of Historic Places or is within a historic district listed on the Register.

8. The appraiser or DE lender is aware of any other condition that could adversely affect the health or safety of the residents of the project.

V. **Project Eligibility Requirements**

The following requirements apply to all Condominium Project approvals:

1. **Minimum number of units:** Projects must consist of two or more units.
2. **Insurance Coverage:** Projects must be covered by hazard and liability insurance and, when applicable, flood and fidelity insurance (See Section VI, Insurance Requirements).
3. **Right of First Refusal:** Right of first refusal is permitted unless it violates discriminatory conduct under the Fair Housing Act regulation at 24 CFR part100.
4. **Commercial Space:** No more than 25 percent of the property's total floor area in a project can be used for commercial purposes. The commercial portion of the project must be of a nature that is homogenous with residential use, which is free of adverse conditions to the occupants of the individual condominium units.
5. **Investor Ownership:** No more than 10 percent of the units may be owned by one investor. This limitation also applies to developers/builders that subsequently rent vacant and unsold units. For condominium projects with ten or fewer units, no single entity may own more than one unit within the project; all units, common elements, and facilities within the project must be 100 percent complete.
6. **Delinquent Home Owners Association (HOA) Dues:** No more than 15 percent of the total units can be in arrears (more than 30 days past due) of their condominium association fee payments.
7. **Pre-sales:** At least 50 percent of the total units must be sold prior to endorsement of a mortgage on any unit. Valid presales include:
 - Copies of sales agreements and evidence that a mortgagee is willing to make the loan¹;
 - Evidence that units have closed and are occupied; **OR**
 - Information from a developer/builder that lists all of the units already sold, under contract, or closed (e.g. a spreadsheet, chart, or listing used for the company's own tracking purposes) that is accompanied by a signed certification from the developer (Attachment F).

¹ Secondary residences can only be included if it meets the requirements of 24 CFR 203.18(f)(2).

8. **Owner-occupancy Ratios:** At least 50 percent of the units of a project must be owner-occupied or sold to owners who intend to occupy the units.² For proposed, under construction or projects still in their initial marketing phase, FHA will allow a minimum owner occupancy amount equal to 50 percent of the number of presold units (the minimum presales requirement of 50 percent still applies).
9. **Legal Phasing:** Legal phasing is permitted for condominium processing. It is recommended that developers submit all known phases for initial project approval. FHA will not accept market phasing in lieu of legal phasing.

For vertical buildings, legal phasing is acceptable if:

- a. The floors are legally phased in groupings of no less than five floors;
- b. At least a temporary certificate of occupancy has been obtained and **all** common areas and amenities have been completed; **AND**
- c. A third party completion bond has been obtained.

For purposes of calculating the owner-occupancy percentage and FHA concentration:

- a. On multi-phased projects the owner-occupancy percentage is calculated on the first declared phase and cumulatively on subsequent phases if the ownership of the condominium project remains the same.
 - b. If multi-phasing includes separate ownership per phase, each phase is calculated individually.
 - c. In single-phase condominium project approval requests, all units are used in the denominator when calculating the 50 percent owner-occupancy percentage.
10. **FHA Concentration:** FHA will display the concentration information for each approved condominium development on the approved condominium listing, which can be found on both FHA Connection and on the public website at www.hud.gov. The concentration level will be based on case numbers assigned on units in a project; FHA will not issue new case numbers once the 30 percent concentration level (plus a small tolerance to accommodate for some fall-out) has been reached in any particular development.
 - a. Projects consisting of three or fewer units will have no more than one unit encumbered with FHA insurance.
 - b. Projects consisting of four or more units will have no more than 30 percent of the total units encumbered with FHA insurance.
 - c. Calculation of the level of FHA concentration in a project declared with legal phases will follow the same methodology as owner-occupancy, described above.
 11. **Budget Review:** Mortgagees must review the homeowners' association budget (the actual budget for established projects or the projected budget for new projects) for all projects. This review must determine that the budget is adequate and:

² Units sold to owners who intend to occupy the units must follow the requirements of a valid presale.

- Includes allocations/line items to ensure sufficient funds are available to maintain and preserve all amenities and features unique to the condominium project;
- Provides for the funding of replacement reserves for capital expenditures and deferred maintenance in an account representing at least 10% of the budget; and
- Provides adequate funding for insurance coverage and deductibles (see Section VI, Insurance Requirements).

In cases where the budget documents do not meet these standards, the mortgagee may request a reserve study to assess the financial stability of the project. The reserve study cannot be more than 12 months old. When reviewing the reserve study, consideration must be given to items that have been replaced after the time that the reserve study was completed.

In lieu of the actual budget documents, mortgagees may request and rely on Fannie Mae form 1073a, Analysis of Annual Income and Expenses – Operating Budget, executed by an authorized representative of the seller/servicer, owners association, or management agent.

VI. Insurance Requirements

- A. The condominium project must be covered by hazard, flood, liability and other insurance required by state or local condominium laws or acceptable to FHA as defined below:
- **Hazard Insurance:** The homeowners association (HOA) is required to maintain adequate “master or blanket” property insurance in an amount equal to 100% of current replacement cost of the condominium exclusive of land, foundation, excavation and other items normally excluded from coverage. If the HOA does not maintain 100% coverage, the unit owner may not obtain “gap” coverage to meet this requirement.
 - **HO-6 Coverage:** In cases where the master policy does not include interior unit coverage, including replacement of interior improvements and betterment coverage to insure improvements that the borrower may have made to the unit, the borrower must obtain a “walls-in” coverage policy (HO-6 policy).
 - **Liability Insurance:** The HOA is required to maintain comprehensive general liability insurance covering all of the common elements, commercial space owned and leased by the owner’s association, and public ways of the condominium project.
 - **Fidelity Bond/Fidelity Insurance:** Fidelity Bond/Fidelity Insurance is required for new and established condominium projects with 20 or more units. The HOA must maintain this insurance for all officers, directors, and employees of the association and all other persons handling or responsible for funds administered by the association. The coverage must be no less than a sum equal to three months aggregate assessments on all units plus reserve funds.

- Flood Insurance: Insurance coverage equal to the replacement cost of the project less land costs or up to the National Flood Insurance Program (NFIP) standard of \$250,000 per unit, whichever is less. In the insuring of a residential condominium building in a regular program community, the maximum limit of building coverage is \$250,000 times the number of units in the building (not to exceed the building's replacement cost). The HOA, not the borrower or individual unit owner, is responsible for obtaining and maintaining adequate flood insurance under the NFIP on buildings located in a Special Flood Hazard Area (SFHA). The flood insurance coverage must protect the interest of borrowers who hold title to an individual unit as well as the common areas of the condominium project. If the FHA Roster Appraiser reports that buildings in a condominium project are located in a SFHA the lender is responsible for ensuring that the HOA obtains and maintains adequate flood insurance on buildings located within the SFHA, per Mortgagee Letter 2009-37.

B. Determining Need for Flood Insurance

Mortgagees must determine whether the property improvements (dwelling and related structures/equipment essential to the value of the property and subject to flood damage) are located in a 100-year flood plain. If the property is in a 100-year flood plain, flood insurance is required, per Mortgagee Letter 2009-37. To demonstrate and document that the property is not located in a 100-year flood plain and not subject to flood insurance requirements, the mortgagee must obtain:

- A final Letter of Map Amendment (LOMA) or
- A final Letter of Map Revision (LOMR)

VII. Manufactured Housing Condominium Projects (MHCP) (effective June 12, 2009)

Pursuant to HERA, manufactured housing condominium projects are now eligible for FHA mortgage insurance. All outstanding and current FHA Manufactured Housing individual unit requirements remain applicable for both Home Equity Conversion Mortgages (HECM) and forward mortgages, including elevations in flood zones and foundation requirements. MHCPs must be submitted to the applicable Homeownership Center (HOC) for review and approval (HRAP). MHCPs are ineligible for DELRAP processing and may **not** be processed as site condominiums.

See Loan Approval section for appraisal reporting requirements.

VIII. Condominium Conversions

Conversion to condominiums occurs in those projects which involve changing the title of an existing structure generally under one title, to property that is separated into units so that the title to most units can be held separately. Changes to condominium conversion requirements are defined below:

1. The one-year waiting period requirement for conversions is eliminated;
2. In the event that FHA is insuring a mortgage on a unit and an undivided interest in the common elements on a project undergoing remodeling or rehabilitation, the entire condominium project, including the common facilities, must be 100 percent completely built before any mortgage may be endorsed. Escrow provisions will be permitted for weather related delays for common areas only.
3. Conversions of properties from non-residential or from rental, whether tenant-occupied or vacant, will be treated as new construction.

IX. Condominium New Construction Pre-approval and Inspection Requirements

This Mortgagee Letter now permits condominium processing consistent with guidance described in Mortgagee Letter 2001-27.

- A. In cases where a building permit and a certificate of occupancy (or its equivalent) are issued by a local jurisdiction that performs a minimum of three inspections (typically the footing, framing and final) neither an Early Start Letter nor a HUD approved ten-year warranty plan is required. For those jurisdictions that do not issue a building permit (or its equivalent) prior to construction and a Certificate of Occupancy (or its equivalent) upon completion of construction, a condominium unit that is one year old or less must have either an Early Start Letter (with a minimum of three inspections by an FHA Roster Inspector) or be covered by a HUD-approved ten-year warranty plan (with a final inspection by a FHA Roster Inspector) to be eligible for high-ratio mortgage insurance. Projects are still required to be on the FHA-approved condominium list.
- B. FHA will require the completion and retention of the following documents when processing new construction condominium project approvals:
 - Builder's Certification of Plans, Specifications and Site, form HUD-92541
 - Builder's Warranty, form HUD-92544
 - Building Permit (or its equivalent)
 - Final Certificate of Occupancy (or its equivalent)
- C. FHA will accept a temporary/conditional Certificate of Occupancy for new construction and conversions that require substantial rehabilitation under the following circumstances:
 - All common areas and amenities for the project must be completed.
 - The temporary/conditional Certificate of Occupancy that was issued clearly indicates that the unit is habitable and eligible for immediate occupancy.

- The jurisdiction that is issuing the temporary/conditional Certificates of Occupancy has in place a standard protocol whereby permanent certificates are issued and maintained.

X. General Processing Steps for DELRAP or HRAP

- A. Determine acceptability of the site and location of the project. Refer to Attachment A, *Condominium Project Approval Matrix* for the list of documents that the project review package must contain.
- B. Review the project's financial and legal documents; if acceptable, authorized personnel will sign and date the Lender Certification of Condominium Requirements (Attachment B).
 - While FHA expects lenders to submit recorded documents with the condominium project approval package, unrecorded properly executed documents are acceptable in the initial request for project approval.
 - If unrecorded documents are utilized, no loan can be *insured* in the project until the recorded documents have been received and the applicable approval data updated.
 - Unrecorded documents for conversions will be acceptable if the conversion was a non-occupied rental building (i.e., warehouse or vacant building converted to a condominium regime) that meets all applicable requirements.
 - Whenever unrecorded documents are submitted, the lender (for HRAP), DELRAP lender or builder/developer must provide a certification with the final recorded documents and description of any changes from original unrecorded documents.
- C. Determine the project's budget is adequate or meets the alternative standards in Project Approval Section, V, 11.
- D. Retain and maintain all documents used to review and approve the project for a period of three years from the date of project approval.
- E. If a project is listed as Rejected or Withdrawn on the FHA-approved condominium list, the project will not be eligible for reconsideration unless the request meets the following:
 - Project was rejected or withdrawn \leq 12 months: new/additional information may be submitted to HUD for reconsideration only under HRAP processing based on the rejection or withdrawal date;
 - Project was rejected or withdrawn $>$ 12 months: new/additional information may be submitted to HUD for processing under HRAP or may be considered by the lender (and ultimately transmitted to HUD) in the case of projects undergoing DELRAP review.

NOTE: If a project is no longer approved or does not meet approval criteria, then only a FHA-to-FHA streamline refinance without an appraisal is allowed.

- F. Second and subsequent lenders that submit a unit for insurance in a project that is listed on the FHA-approved condominium list are not required to complete any further approval process. However, as part of loan-level review, FHA will require the lender to certify (Attachment C) it has no knowledge of circumstances or conditions that might have an adverse effect on the project or cause a mortgage secured by a unit in the project to become delinquent. FHA will also require the lender to certify (Attachment C) that it has reviewed and verified the condominium project's continued compliance with the initial approval requirements regarding investor ownership, percentage of owners in arrears for condominium association fees, owner-occupancy rate and FHA loan concentration rate, and the lender certifies (Attachment C) that the condominium project continues to comply with FHA requirements.
- G. Subsequent phases being approved by a different lender must follow the general procedures listed under this Section of the ML. The original lender must also follow these general procedures but will have already satisfied some of the steps listed.
- H. All required certifications, as applicable, must be included in the FHA case binder submitted for insurance endorsement.
- I. For both new construction and conversions the developer should complete form HUD-92541, Builder's Certification of Plans, Specification and Site. If the developer/builder intends to market five or more units within the next 12 months with FHA mortgage insurance and block 11 "a, b, c, or d" is not checked, the developer/builder is required to complete Form HUD-935.2C, Affirmative Fair Housing Marketing Plan – Condominium or Cooperatives. This completed form must be submitted to the Director of the Processing and Underwriting Division in the jurisdictional HOC for approval (prior to project approval).
- J. Environmental reviews will be required only for proposed and under construction project approvals submitted under the HRAP option consistent with the Environmental Review Requirements listed in Project Approval section, numeral IV, B. Environmental review is not required under DELRAP, but the lender **must** take necessary actions to avoid or determine that there are mitigants to addressing identified environmental conditions prior to completing its project review.
- K. Transfer of control of the Homeowners Association shall pass to the unit owners within the project no later than the latest of the following:
1. 120 days after the date by which 75 percent of the units have been conveyed to the unit purchasers;
 2. Three years after completion of the project evidenced by the first conveyance to a unit purchaser; OR
 3. The time frame established under state or local condominium laws if specific provisions regarding transfer of control exist.

XI. Certification for Initial Project Approval

A. Lender Certification

Lenders must provide certifications on company letterhead signed by a company authorized representative (signature stamps or electronic signatures are not authorized) that:

1. The eligible condominium project complies with applicable FHA requirements addressed within this ML;
2. All condominium legal documents meet HUD regulations, state and local condominium laws; and
3. Pre-sale, owner occupancy and FHA concentration ratios are met.

B. Developer Certification

The developer/builder must provide a certification (Attachment E) on company letterhead signed and dated by an authorized representative of the developer/builder (signature stamps or electronic signatures are not authorized) which states that:

1. The eligible condominium project complies with all applicable FHA requirements addressed in this ML; and
2. All condominium documents meet all HUD requirements, and state and local requirements.

NOTE: FHA will not require an attorney's certification. However, lenders and developers/builders may obtain this as part of their own due diligence process. Lenders as well as developers/builders are reminded that this document will not replace other required condominium certifications they are required to execute (*e.g.*, Applicable Appendices B, C, E and F of this Mortgage Letter).

XII. Recertification of Project Approvals

Condominium Project approvals will expire two years from the date of placement on the list of approved condominiums. Further participation in the program after this two-year period has expired will require recertification to determine that the project is still in compliance with HUD's owner-occupancy requirement and that no conditions currently exist which would present an unacceptable risk to FHA. Items that must be given consideration are:

1. Pending special assessments,
2. Pending legal action against the condominium association, or its officers or directors, and
3. Adequate hazard, liability insurance, and when applicable, flood insurance coverage.

LOAN APPROVAL

I. Mortgage Insurance for Individual Unit Financing

All applicable, outstanding and any additional FHA mortgage insurance requirements not defined in this ML must be satisfied for individual units.

II. Recordation of Documents

If unrecorded documents were submitted along with other required documentation for initial project approval, no loan can be *insured* in the project until the recorded documents are received and the applicable approval data updated.

III. Insurance Requirements

A. Hazard Insurance

For forward mortgages, in cases where the master policy *does not* include interior unit coverage, including replacement of interior improvements and betterment coverage to insure improvements that the borrower may have made to the unit, the borrower must obtain a “walls-in” coverage policy (HO-6 policy).

For Home Equity Conversion Mortgages (reverse mortgages), the borrower must obtain and maintain hazard insurance equal to the value of insurable property improvements, per Handbook 4235, REV 1, Chapter 6.

B. Flood Insurance

For both forward and reverse mortgages, lenders must ensure that the Homeowners Association (HOA), not the individual owner, obtains and maintains adequate flood insurance under the National Flood Insurance Program on buildings located within a Special Flood Hazard Area. The insurance coverage must protect the interest of borrowers who hold title to an individual unit as well as the common areas. See Section VI, Insurance Requirements.

IV. Certifications

If a project has been previously approved, the lender must certify that it has reviewed and verified the condominium project’s continued compliance with the initial approval requirements regarding investor ownership, percentage of owners in arrears for condominium association fees, owner-occupancy rate and FHA loan concentration rate, and the Lender certifies that the condominium project continues to comply with FHA requirements.

V. FHA-to-FHA Transactions

Project Approval is not required for:

- a. FHA-to-FHA streamline refinance transactions or
- b. FHA/HUD Real Estate Owned (REO).

VI. Site Condominiums

Although processed as Section 203(b) loans, the applicable ADP codes for Site Condominiums are 731 (Adjustable Rate Mortgages) and 734.

Appraisal data is collected and reported on Fannie Mae form 1004, in accordance with the Valuation Protocols, Appendix D of HUD Handbook 4150.2.

The Condominium Rider (Attachment D) must be included in the FHA case binder submitted for insurance endorsement.

VII. Manufactured Housing Condominium

The appraisal reporting requirements for condominium manufactured homes are:

1. Appraisal must be reported on the Manufactured Home Appraisal Report (Fannie Mae Form 1004C).
2. Subject condominium project must be inspected and the Project Information section of the Individual Condominium Unit Appraisal Report (Fannie Mae Form 1073) must be completed and included as an addendum to the appraisal report.
3. Comparable sales must be condominium manufactured homes. Detailed explanations must be provided when search parameters are expanded due to the lack of comparable sales in subject market area.

VIII. “Spot Loan” Approval Process

The Spot Loan Approval Process as defined in Mortgage Letter 1996-41 is eliminated. The DELRAP and HRAP have been streamlined to allow for uncomplicated condominium project approvals eliminating the need to approve units on a “spot loan” basis.

LIABILITIES AND MONITORING

I. Mortgagee Liability

Mortgagees who issue condominium project approvals using the DELRAP process are responsible for material deficiencies associated with the project approval and any loan they originate and/or underwrite using the applicable project approval.

Mortgagees who rely upon a condominium project approval issued by another mortgagee are responsible for the loan level certification (Attachment C). With this certification, the lender is confirming that the company has no knowledge of circumstances or conditions that might have an adverse effect on the project or cause a mortgage secured by a unit in the project to become delinquent. The lender is also certifying that it has reviewed and verified the condominium project's continued compliance with the initial approval requirements regarding investor ownership, percentage of owners in arrears for condominium association fees, owner-occupancy rate and FHA loan concentration rate, and it certifies that the condominium project continues to comply with FHA requirements.

II. Quality Assurance

Monitoring the condominium approval process is critical to the success of the program. Lenders who approve condominium projects utilizing the DELRAP option will be required to submit a copy of the complete condominium project approval package to the applicable Homeownership Center within five (5) business days of approval. Lenders are required to submit the first five DELRAP approvals for review. Further, to manage FHA's risk, and ensure compliance with all condominium project policy requirements, additional condominium project approvals will be selected for review. The criteria for selection of the additional approvals will be determined and lenders will be notified in future guidance.

III. False Certifications

Title 18 U.S.C. 1014, provides in part that whoever knowingly and willfully makes or uses a document containing any false, fictitious, or fraudulent statement or entry, in any matter in the jurisdiction of any department or agency of the United States, shall be fined not more than \$1,000,000 or imprisoned for not more than 30 years or both. In addition, violation of this or others may result in debarment and civil liability for damages suffered by the Department.

TRANSITION STRATEGY

FHA will move all currently approved condominium projects to the new approval list and FHA Connection database. The following requirements are applicable based on the date of the initial project approval. Additional guidance on new data entry requirements will be issued in a separate ML.

- Projects that received approval prior to October 1, 2008, will require recertification on or before December 7, 2010.
- Projects that received approval between October 1, 2008 through December 7, 2009, will follow the recertification requirements defined in the Project Approval Section, XIII.

Recertification of approved condominium projects may be processed by HUD using HRAP or by a mortgagee under DELRAP. The DELRAP option is only available to lenders who have unconditional Direct Endorsement authority and staff with knowledge and expertise in reviewing and approving condominium projects.

If you have questions regarding this Mortgagee Letter, please call the FHA's Resource Center at 1-800-CALL-FHA (1-800-225-5342). Persons with hearing or speech impairments may access this number via TDD/TTY by calling 1-877-TDD-2HUD (1-877-833-2483).

Sincerely,

David H. Stevens
Assistant Secretary for Housing-
Federal Housing Commissioner

Attachments

Attachment A

Condominium Project Approval Matrix

		Proposed/UC	Existing	Conversion
1	<u>All Condominium Legal Documents</u>	x	x	x
a	<u>Recorded Plat Map indicating Legal Description</u>	x	x	x
b	<u>Recorded Covenants, Conditions and Restrictions (CC&R's)</u>	x	x	x
c	<u>Signed and Adopted Bylaws</u>	x	x	x
d	<u>Articles of Incorporation filed with the State</u>	x	x	x
e	<u>Recorded Condominium Site Plans</u>	x	x	x
2	<u>Plan or Evidence of Transfer of Control</u>	x	x	x
3	<u>Proposed or Actual Budget</u>	x	x	x
4	<u>Management Agreement, if applicable</u>	x	x	x
5	<u>Equal Employment Opportunity Certificate (Form HUD 92010)</u>	x		
6	<u>Builder's Certification of Plans, Specifications and Site, Form HUD-92541</u>	x		x
7	<u>FEMA Flood Map</u>	x	x	x
8	<u>Estimated Construction Completion Date</u>	x		x
9	<u>Outstanding or Pending Litigation Analysis</u>		x	x
10	<u>Pending Special Assessment Analysis</u>		x	

Attachment B**LENDER CERTIFICATION TO CONDOMINIUM REQUIREMENTS**

The undersigned hereby certifies that (1) the Lender has reviewed the project and it meets all requirements of Section 203(b) of the National Housing Act, 24 CFR part 203, State and local condominium laws and any Mortgage Letters thereto applicable to the review of condominiums; (2) to the best of his or her knowledge and belief, the information and statements contained in this application are true and correct, and (3) the Lender has no knowledge of circumstances or conditions that might have an adverse effect on the project or cause a mortgage secured by a unit in the project to become delinquent (including but not limited to: defects in construction; substantial disputes or dissatisfaction among unit owners about the operation of the project or the owner's association; and disputes concerning unit owners; rights privileges, and obligations). The undersigned understands and agrees that the Lender is under a continuing obligation to inform HUD if any material information compiled for the review and acceptance of this project is no longer true and correct.

Authorized Lender Representative
(Signature and Title)

Date

Title 18 U.S.C. 1014, provides in part that whoever knowingly and willfully makes or uses a document containing any false, fictitious, or fraudulent statement or entry, in any matter in the jurisdiction of any department or agency of the United States, shall be fined not more than \$1,000,000 or imprisoned for not more than 30 years or both. In addition, violation of this or others may result in debarment and civil liability for damages suffered by the Department.

Attachment C**LENDER CERTIFICATION FOR INDIVIDUAL UNIT FINANCING**

The undersigned hereby certifies that (1) the Lender has verified the condominium unit in connection with this loan file has been verified to be in a project that appears on FHA's list of approved condominium projects; (2) to the best of his or her knowledge and belief, the information and statements contained in this application are true and correct; (3) the Lender has no knowledge of circumstances or conditions that might have an adverse effect on the project or cause a mortgage secured by a unit in the project to become delinquent (including but not limited to: defects in construction; substantial disputes or dissatisfaction among unit owners about the operation of the project or the owner's association; and disputes concerning unit owners; rights privileges, and obligations); and (4) the Lender has reviewed and verified the condominium project's continued compliance with the initial approval requirements regarding investor ownership, percentage of owners in arrears for condominium association fees, pre-sale ratio, owner-occupancy ratio, FHA loan concentration ratio, and the Lender certifies that the condominium project continues to comply with FHA requirements.

Authorized Lender Representative
(Signature and Title)

Date

Title 18 U.S.C. 1014, provides in part that whoever knowingly and willfully makes or uses a document containing any false, fictitious, or fraudulent statement or entry, in any matter in the jurisdiction of any department or agency of the United States, shall be fined not more than \$1,000,000 or imprisoned for not more than 30 years or both. In addition, violation of this or others may result in debarment and civil liability for damages suffered by the Department.

Attachment D

CONDOMINIUM RIDER

THIS CONDOMINIUM RIDER is made this _____ day of _____, 20____, and is incorporated into and shall be deemed to amend and supplement the Mortgage, Deed of Trust or Security Deed ("Security Instrument") of the same date given by the undersigned ("Borrower") to secure Borrower's Note ("Note") to _____ ("Lender") of the same date and covering the Property described in the Security Instrument and located at:

[Property Address]

The Property includes a unit in, together with an undivided interest in the common elements of, a condominium project known as:

[Name of Condominium Project]

("Condominium Project"). If the owners association or other entity which acts for the Condominium Project ("Owners Association") holds title to property for the benefit or use of its members or shareholders, the Property also includes Borrower's interest in the Owners Association and the uses, proceeds and benefits of Borrower's interest.

CONDOMINIUM COVENANTS. In addition to the covenants and agreements made in the Security Instrument, Borrower and Lender further covenant and agree as follows:

So long as the Owners Association maintains, with a generally accepted insurance carrier, a "master" or "blanket" policy insuring all property subject to the condominium documents, including all improvements now existing or hereafter erected on the Property, and such policy is satisfactory to Lender and provides insurance coverage in the amounts, for the periods, and against the hazards lender requires, including fire and other hazards included within the term "extended coverage," and loss by flood, to the extent required by the Secretary, then: (i) Lender waives the provision in the Security Instrument for the monthly payment to Lender of one-twelfth of the yearly premium installments for hazard insurance on the Property, and (ii) Borrower's obligation under the Security Instrument to maintain hazard insurance coverage on the Property is deemed satisfied to the extent that the required coverage is provided by the Owners Association policy. Borrower shall give Lender prompt notice of any lapse in required hazard insurance coverage and of any loss occurring from a hazard. In the event of a distribution of hazard insurance proceeds in lieu of restoration or repair following a loss to the Property, whether to the condominium unit or to the common elements, any proceeds payable to Borrower are hereby assigned and shall be paid to Lender for application to the sums secured by this Security Instrument, with any excess paid to the entity legally entitled thereto.

Borrower promises to pay all dues and assessments imposed pursuant to the legal instruments creating and governing the Condominium Project.

If Borrower does not pay condominium dues and assessments when due, then Lender may pay them. Any amounts disbursed by Lender under this paragraph shall become additional debt of Borrower secured by the Security Instrument. Unless Borrower and Lender agree to other terms of payment, these amounts shall bear interest from the date of disbursement at the Note rate and shall be payable, with interest, upon notice from Lender to Borrower requesting payment.

BY SIGNING BELOW, Borrower accepts and agrees to the terms and provisions contained in this Condominium Rider.

(SEAL)
Borrower

(SEAL)
Borrower

[ADD ANY NECESSARY ACKNOWLEDGEMENT PROVISIONS.]

Attachment E**DEVELOPER/BUILDER CERTIFICATION TO CONDOMINIUM REQUIREMENTS**

The undersigned hereby certifies that (1) the Developer/Builder has reviewed the project and it meets all requirements of Section 203(b) of the National Housing Act, 24 CFR 203, State and local condominium laws and any Mortgage Letters thereto applicable to the review of condominiums; (2) to the best of his or her knowledge and belief, the information and statements contained in this application are true and correct, and (3) the Developer/Builder has no knowledge of circumstances or conditions that might have an adverse effect on the project or cause a mortgage secured by a unit in the project to become delinquent (including but not limited to: defects in construction; substantial disputes or dissatisfaction among unit owners about the operation of the project or the owner's association; and disputes concerning unit owners; rights privileges, and obligations). The undersigned understands and agrees that the Developer/Builder is under a continuing obligation to inform HUD if any material information compiled for the review and acceptance of this project is no longer true and correct.

Authorized Representative
(Signature and Title)

Date

Title 18 U.S.C. 1014, provides in part that whoever knowingly and willfully makes or uses a document containing any false, fictitious, or fraudulent statement or entry, in any matter in the jurisdiction of any department or agency of the United States, shall be fined not more than \$1,000,000 or imprisoned for not more than 30 years or both. In addition, violation of this or others may result in debarment and civil liability for damages suffered by the Department.

Attachment F**DEVELOPER/BUILDER PRESALES CERTIFICATION**

The undersigned hereby certifies that in lieu of providing (1) Copies of sales agreements and evidence that a mortgagee has issued approval; or (2) Evidence that units have closed and are occupied; the Developer/Builder has attached to the signed and dated certification, a list documenting all units sold, under contract or closed (i.e., and excel spreadsheet). This information will be used to document the required minimum presale requirement of 50 percent.

Authorized Representative
(Signature and Title)

Date

Title 18 U.S.C. 1014, provides in part that whoever knowingly and willfully makes or uses a document containing any false, fictitious, or fraudulent statement or entry, in any matter in the jurisdiction of any department or agency of the United States, shall be fined not more than \$1,000,000 or imprisoned for not more than 30 years or both. In addition, violation of this or others may result in debarment and civil liability for damages suffered by the Department.