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Condominium Deconversion: What Is It and How Does It Work?

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Condominium Deconversion: What Is It and How Does It Work?

April 21, 2021

Presented by:

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Illinois Condominium Property Act (ICPA)

Key Sections to Consider

- **Section 16 – Removal of Property from ICPA**
- **Section 15 – Sale of the Property**
- **Section 18.4 – Powers and Duties of the Board of Managers**
 - Fiduciary Duty of Board to Unit Owners
 - See also *Kai v. Board of Directors of Spring Hill Building I Condominium Ass'n* 2020 IL App (2d) 190642 (June 3, 2020)



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What does Condominium Deconversion Mean?

- *Condominium Deconversion* is NOT a legal term.
- Most precisely, it refers to removal of property from the provisions of the Illinois Condominium Property Act (ICPA).
- It most commonly is used to *convert a residential condominium property to an apartment building* – but it can be used for any type of condominium.
- Section 16 of ICPA provides for Removal.



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Removal of Property from ICPA

- **Section 16 is pretty simple:**

- All Unit Owners, with the consent of the holders of all liens affecting the units, may remove property from the provisions of the ICPA by recording an instrument to that effect.
- Upon removal, the property shall be deemed to be owned in common by all (*former*) unit owners in accordance with the percentages previously owned in the common elements.
- Liens on units will be transferred to the undivided interest of the unit owner.



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Practical Ramifications if There Are Multiple Owners upon Removal

- **Unit owners become Tenants in Common.**
 - Tenants in Common have equal rights to possess the whole property.
- **Liens are transferred to only a percentage share of the whole.**
 - If they foreclose, they get only an undivided percentage interest.



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Solution

- Have only one owner and one lienholder at time of Removal of the Property from the provisions of the ICPA.



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How Do We Consolidate Ownership into One Owner with One Lienholder?

- There are at least two ways, but first ...
 - Why is Condominium Deconversion a hot topic?



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Market Conditions

- **During the *Great Recession* (technically, from December 2007 to June 2009 – but for residential real estate, from March 2007 to mid-2017):**
 - Property values dropped dramatically (roughly 45% to 50%).
 - Often, mortgages far exceeded the value of property.
 - Foreclosures skyrocketed.
 - Condo unit owners quit paying assessments.
 - Condominium Associations had little money and were forced to defer maintenance.
 - Deterioration of common elements
 - Building Violations and Fines



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Great Recession Aftermath

- Condominium Associations raised regular and special assessments out of necessity to catch up financially.
- Investors bought units at low market values to rent out to tenants at rising rental values.



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Residential Rental Properties

- Residential Rental Properties became (and still are) hot investment opportunities.
 - Availability of Long-Term Low Interest Rates
 - Rising Rents
 - Everyone must live somewhere.



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Values Inverted About 8 to 10 Years Ago

- *Single-owner apartment buildings became worth about 140% to 170% more than the aggregate fair market value of all units as condominiums.*



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Win-Win?

- **Investors can:**
 - *pay condominium unit owners 10% to 15% above fair market value for each condominium unit (**Unit Owner WIN**); and*
 - *after allocating funds to make capital expenditures to address deferred maintenance and to renovate or update units, still make a nice profit (**Investor WIN**).*
- ***What could possibly go wrong?***
- ***Thus, was born the condominium deconversion craze.***



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Back to Section 16 – Removal from the ICPA

- Earlier, I said there were at least two ways to get to a single owner of all units and a single lienholder to make removal of a condominium property from the provisions of the ICPA (deconversion) practical.



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Two Ways to Consolidate Ownership

- Herding Cats
- Section 15



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Herding Cats Method of Unit Ownership Consolidation

- **Assume a Condominium Association with 20 Units, each with a separate owner.**
 - One buyer wants to own them all. Assume all unit owners are willing to sell.
 - Twenty purchase contracts, with possibly twenty different Sellers' attorneys, each with a preferred title company, demanding a closing at a time and place convenient to the unit owner and its attorney.
- **Now imagine a condo association with 40, 80, 100, 400 units – or more. Good Luck!**



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An Additional *Herding Cats* Problem

- Often, a prospective purchaser seeking to “deconvert” and its lender will not wish to purchase *any* of the units unless the purchaser can acquire *all* units.
- Remember the Section 16 requirement.
 - It takes 100% of all unit owners with the consent of all lienholders to remove the property from the provisions of the ICPA.



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The *Section 15* Solution

- Section 15 of the ICPA provides that the owners of 75% of the unit ownership (for an association of four or more units) may vote to sell the entire the Property as a whole.
 - In Chicago, the percentage is 85%. [Chicago Code Section 13-72-085]
 - If the requisite percentage of owners vote to sell the property, all unit owners must sell.



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Section 15 Approval

- Unless the Declaration or Bylaws require a higher percentage, the Approval to sell pursuant to Section 15 requires the **AFFIRMATIVE APPROVAL** of 75% (85% in Chicago).
 - 75% of the total percentage interest (85% in Chicago) must vote YES to approve the sale.
 - Effectively, an abstention from voting counts as a NO vote.
- **If APPROVED:**
 - *It shall thereupon become the duty of every unit owner to execute and deliver such instruments and to perform all acts as in manner and form may be necessary to effect such sale ... subject to certain (limited) unit owner protections specified in Section 15.*



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Origins of Section 15

- **Forced sales pursuant to Section 15 have become highly controversial over the past 8 to 10 years. It has been actively used only since the Great Recession.**
- **Although some claim it was “snuck-into the Act” by predatory investors, in fact, it has been part of the Act since the ICPA was first enacted effective July 1, 1963.**
- **Question:**
 - Is this a risk residential real estate lawyers should have been warning their condominium unit buyers about all-along?



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Section 15 Controversy

- If each unit owner is to receive 10% to 15% above fair market value, why might they oppose a sale?
- What if:
 - the unit is their primary residence;
 - they love their home, they love their views, they love their neighbors, they love their neighborhood;
 - they have a long-term low-interest mortgage they can easily afford?
 - Life is perfect! They don't want to sell.
- Under Section 15, if 75% (85% in Chicago) of unit owners vote to sell, *ALL* unit owners *must* sell.



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How are unit owners protected – if at all?

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Unit Owner Protections Against a Section 15 Sale

- 75% affirmative approval (85% in Chicago) is a high threshold.
- Organized Unit Owner opposition can work.
- Bulk-owners of units (owners of multiple units) can distort the approval process making it easier to obtain approval.



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Unit Owner Protections Against a Section 15 Sale

- **Investor-owners more inclined to accept a premium of 10% to 15% over FMV is typical.**
 - Investors are in it for the money.
- **Rental restrictions can discourage a high percentage of investor-owners.**
 - Unit Owners can include in the Declaration a limit on the percentage of units that can be leased.



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Unit Owner Protections if a Section 15 Sale Is Approved

- A vote to sell is binding upon all unit owners.
- If the requisite percentage votes to Approve a Section 15 sale, are unit owners voting against the sale protected?
 - Short Answer: *Maybe ... Sort of ...*



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Section 15 Unit Owners Protections

Objecting to the Sale

- Within 20 days after the vote Approving a sale, a unit owner who did not vote in favor may file a written objection to the sale with the manager or the board of managers.
- Even if a written objection is timely filed, the unit owner must still cooperate in selling its unit.



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Effect of Written Objection to Sale

- **15(a): If a unit owner timely files a written objection to sale, he/she shall be entitled to receive the greater of:**
 - (i) the value of his or her interest, as determined by fair appraisal; or
 - (ii) the outstanding balance of any *bona fide debt* secured by the unit owner's interest, which was incurred by such unit owner in connection with the acquisition of refinance of the unit owner's interest
- **In either case, less any unpaid assessments or charges due from such owner.**
- **Also entitled to certain relocation expenses.**



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Section 15 Fair Appraisal Process

- **The appraisal process is specified at Section 15(b).**
 - Unit owner may designate an appraiser.
 - In which event, the prospective purchaser shall designate an appraiser.
 - These two appraisers shall mutually designate a third appraiser, creating a “panel of appraisers”.
 - The panel of appraisers shall determine, by a vote of at least two, the value of the unit interest.



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The Appraisal “Risk”

- Note that Section 15(a) states that the objecting unit owner has the right to receive from the sale proceeds the value of its unit interest determined by “fair appraisal.”
- The *panel of appraisers* will determine the value by a vote of at least two of the three appraisers.
- What if the value determined by fair appraisal is less than the amount originally allocated under the Purchase Agreement?
 - Answer: Unit Owner gets the *lower value determined by appraisal.*



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Is the Appraisal Risk a Real Risk?

- Under Current market conditions, the value of a “deconverted” apartment building is often 140% to 170% greater than the aggregate value of all individual condominium units.
- In Section 15 sales, it is common for prospective buyers to offer a premium purchase price of 110% to 115% of fair market value for each individual unit.
- Appraisals determine only Fair Market Value.
 - Result: The appraised value may well be 10% to 15% less than the offered price.



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Relocation Expense

- In addition to greater of appraised value or amount of underwater mortgage:
 - Objecting owner is also entitled to receive:
 - 15(a): “reimbursement for reasonable relocation costs, determined in the same manner as under the federal ***Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970***, as amended from time to time and as implemented by regulations promulgated under the that Act.”



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Relocation Expense

- In addition to greater of appraised value or amount of underwater mortgage:
 - To determine that amount:
 - *See: 42 USC § 4622 and § 4623*
 - Not just § 4622(b).
 - *See also: 49 CFR Part 24 Subpart D § 24.301 and 49 CFR Part 24 Subpart E: Replacement Housing Payments § 24.401(b).*
 - Not just § 24.301(i) *Fixed Residential Moving Cost Schedule*



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Board of Managers Overreach?

- Unit owners opposed to deconversion often complain that their board of managers breach their fiduciary duty to unit owners by advocating for a Section 15 sale.
- Question:
 - Are Board Members fiduciaries?



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Board Members Are Fiduciaries to Unit Owners

- Section 18.4 of the ICPA expressly provides that board members shall exercise the care required of a fiduciary of the unit owners.
- Many cases provide the same.
 - See materials for case citations.
- *Kai v. Board of Directors of Spring Hill Building I Condominium Ass'n* 2020 IL App (2d) 190642 (June 3, 2020), specifically holds that the full common-law scope of fiduciary duties apply to bulk sales under Section 15.



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What Are the Fiduciary Duties of Board Members?

- **Strict duties to treat unit owners with:**
 - utmost candor;
 - rectitude (i.e., morally correct behavior and righteousness);
 - care;
 - loyalty; and
 - good faith ...
- **requiring them to exercise the highest degree of honesty,**
 - thereby prohibiting enhancement of their personal interests at the expense of the interests of the enterprise of other unit owners.
- ***Kai v. Board of Directors of Spring Hill Building I***
***Condominium Ass'n* 2020 IL App (2d) 190642 (June 3, 2020)**



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Fiduciary Duties of Board Members

- If board members owe a fiduciary duty to *all unit owners*, should they remain neutral unless and until the Approval of Sale is granted?



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Board Member Advocacy for Section 15 Sale

■ What is the motivation?

- Does the fact that board members often own more than one unit in the condominium make a difference?
 - 15% purchase price premium times “x” units.
- Does the fact that board members may (coincidentally) receive the top level of “upgrade allowance” offered in many Section 15 Sale Agreements make a difference?
- Does the fact that Board members are being advised by association attorneys who will be the sole Closing Attorneys, receiving a closing attorneys’ fee for *each unit* and a residential title insurance agent *title-split* for *each unit* make a difference?



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Pending Legislation

- A significant amount of legislation is currently pending before the 102nd Illinois General Assembly seeking to address perceived abuses relating to “Condominium Deconversion” issues generally, and the power struggle between condominium boards and unit owners.
- Stay tuned . . .



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