The Problem with Rentals in Condominiums (and Some Possible Solutions)

Part II

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Part I of this article (published in the last UCOM Newsletter) discussed some of the fundamental issues that rentals in condominiums present to the modern day board. In Part II of this article, we take a look at other types of rental restrictions, as well as the key roles that "grandfathering" and "hardship" exemptions often play in the adoption of rental restriction amendments.

I. Other Types of Rental Restrictions: Rental Bans and Waiting Periods

In addition to rental caps, two other kinds of restrictions are worth mentioning: the complete "rental ban," and the "waiting period."

Condominium associations may adopt amendments to their documents "as to the rental of condominium units or terms of occupancy." An association that previously allowed rentals could adopt a bylaw amendment that flatly prohibits all rentals in the condominium, subject only to the minimum grandfathering required for existing written leases under MCL § 559.212 (1).[1] As each existing written lease expired, the co-owner of the unit would be forbidden from re-leasing the unit. Such a condominium would be "rental-free" upon the expiration of the last existing written lease.

The approval of 66 2/3% of the co-owners is required to adopt a bylaw amendment. The adoption of a flat rental ban becomes increasingly difficult as the number of landlord co-owners approaches 33 1/3 % of the community. One can assume that all (or nearly all) of the landlord co-owners would vote against the adoption of such a ban. A number of co-owners who are not renting their units might also vote against a rental ban, since it will prevent them from ever being able to rent out their units. Every co-owner can likely envision a situation where renting out his or her unit might be a desirable economic option (e.g., if co-owner has to relocate due to a job change, military service, etc.). In light of these factors, it becomes apparent why the "rental ban" is the least-favored type of rental restriction that associations seek to adopt.

A "waiting period" restriction prohibits a co-owner from renting out his or her unit for a certain time period after the purchase of the unit (typically one year). The restriction also usually requires the co-owner to reside in the unit during the waiting period.

Often an association will combine a waiting period restriction with a rental cap as a two-pronged approach to limiting rentals and discouraging investor ownership. Although no published Michigan case law exists affirming the validity of these types of restrictions, both of them would appear to be fully authorized under the Condominium Act. The biggest obstacles that associations face in attempting to adopt such restrictions are usually political rather than legal in nature.

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[1] Although a full discussion of the topic is beyond the scope of this article, the reader should be aware that HUD may find any condominium whose bylaws completely prohibit rentals as being ineligible for FHA certification. See 24 CFR § 203.41 (a) (3) and Mortgagee Letter 2011-22. In order to avoid this problem, HUD has recommended that associations seeking to prohibit rentals should allow at least one unit in the condominium to be rented (i.e., adopt a rental cap of one unit). According to HUD, a one-unit rental cap would render the association eligible for FHA certification, at least in regard to that particular requirement.

II. Drafting "Grandfathering" Exemptions for Existing Rental Units – How Much is Enough?

MCL § 559.212 (1), provides that rental restriction amendments "shall not affect the rights of any lessors or lessees under a written lease otherwise in compliance with [MCL § 559.212] and executed before the effective date of the amendment, or condominium units that are owned or leased by the developer."

Note that the Act does not require an association to exempt all currently leased units from document amendments that impose rental restrictions, nor does it demand exemptions for all co-owners who currently lease units. However, the association can include additional exemptions in a rental restriction amendment, especially if doing so makes the amendment more palatable to the membership.

The minimal grandfathering afforded to existing rentals under the Act is likely to be insufficient (and impractical) for many associations. Communities that already have a substantial number of landlords are likely to strongly oppose any amendment that only grants them the minimal "Condominium Act-style" exemption for existing written leases. Many landlords purchase their condominium units solely for the purpose of utilizing it as a rental property. Any proposed rental cap, ban or waiting period that results in landlord co-owners losing their existing right to lease will likely be opposed by those co-owners.

It may make the most sense to exempt any and all units that are currently rented until they are sold or otherwise conveyed to a new owner. This will help re-assure the existing landlords in the community that the investments they have made in their rental properties will not be jeopardized by the new restrictions. Indeed, the new restrictions can be "sold" as a positive to landlord co-owners in that they will provide the landlords with a "monopoly" over rental units in the community, further enhancing the value of their rental properties in that respect.

This type of grandfathering is also easier to manage administratively for the Association, as the Board will not have to track which existing lease expires first after the enactment of the amendments in order to determine who loses their right to lease their units. Since all existing rental units are grandfathered, the Board avoids any arguments that might result with (or between) landlords who might lose their right to lease just because the Association was over the cap number at the time when that landlord co-owner's particular lease expired.

There are a few drawbacks that might result under a "grandfathered until the unit is sold" system. If the Condominium has a significant number of rentals already, it may take many years for enough units in the Project to change hands so that the amendment has any appreciable effect on the community. Thus, for the community looking for immediate relief from a high level of rentals, such grandfathering may seem to largely defeat the purpose for which the amendments were intended in the first place. Nevertheless, if the community is already rental-heavy, the enactment of a rental amendment with a "grandfathered until the unit is sold" exemption may be the only type of rental amendment that the community can realistically expect to pass a vote of the co-owners.

The moral of the story is that the greater number of rentals a community already has, the more likely extensive grandfathering will be needed as part of the amendment proposal in order for it to be approved.

II. The Viability of "Hardship" Exemptions

In adopting rental restrictions, boards often wish to include a "safety valve" that allows the Association to grant an exemption from some (or all) of the restrictions under certain circumstances. Such provisions may give the board the power to grant an exemption from the leasing restrictions to

a co-owner if the board wishes to do so, "in its sole discretion," without specifying any distinct criteria that the co-owner must satisfy in order to be entitled to the exemption. More thoughtfully drafted exemptions might provide that the board can choose to grant an exemption to a co-owner if he or she demonstrates some type of "undue hardship" to the board (either personal or financial).

Provisions that give a board total discretion to grant co-owners exemptions from leasing restrictions without requiring consideration of any objective criteria are problematic for at least two distinct reasons. First, exemptions that give the board such open-ended rights to grant exemptions are likely to invite challenges from co-owners. If the board denies a co-owner's request for an exemption, the co-owner may claim that he or she was treated differently that another co-owner to whom the Board did grant an exemption.

If the board cannot cite any objectively-defined criteria or standards as a basis for its decision, then the challenging co-owner may be able to present a convincing argument in court that the board's denial of the exemption was arbitrary or unreasonable (or worse yet, discriminatory). A court is much more likely to second-guess (and overturn) a board's decision to deny a rental restriction exemption if the court finds that the board issued the denial without any reason for doing so. A provision that grants a board unlimited power to approve or deny rental restriction exemption "in its sole discretion" almost inherently subjects the board to greater legal scrutiny and risk.

"Sole discretion" exemptions can also create complications for mortgage financing within a condominium. The U.S. Department of Housing and Urban Development ("HUD") has interpreted the requirements for FHA certification of condominiums to prohibit any bylaw provision that might give an association's board of directors the unlimited power to "pick and choose" acceptable tenants for the condominium. HUD's general concern behind this rule is that such provisions could be abused by boards who might wish to discriminate against certain classes of individuals and keep them out of the condominium. HUD has refused to grant FHA certification to condominiums if their bylaws give the directors such unfettered power to grant exemptions from lease restrictions.

In order to avoid the problems that can arise under such "sole discretion" provisions, the association should include provisions in the bylaws objectively defining those circumstances under which co-owners will be entitled to an exemption from the rental restrictions. The "objective" criteria can include such things as co-owner relocation due to a job transfer, the co-owner being transferred to an extended care medical facility, or any other objectively verifiable hardships relating to the health of the co-owner. By clearly defining the particular circumstances under which a co-owner might be entitled to an exemption, the association can greatly increase its ability to successfully dispute any co-owner who might claim that the board acted arbitrarily or in a discriminatory fashion in denying the co-owner's request. Including such objective criteria in the bylaws should also satisfactorily address HUD's concerns about such exemptions.

IV. Conclusion

Rental restrictions continue to be a very hot topic for many condominium communities. Rental restrictions can take a variety of forms, but a board should take the "temperature" of the community before proposing any such amendments. A rental restriction should be properly tailored to the needs and wants of the association, including appropriate grandfathering provisions as might be needed to assist with the passing of the amendments. Both federal and state laws need to be considered in the drafting amendments; all such proposals should be carefully reviewed by the association's legal counsel to ensure that they comply with the Condominium Act and do not create any unintended complications for FHA certification and/or for Fannie Mae or Freddie Mac mortgage lending purposes. Rental restriction amendments that are well-drafted and thoroughly vetted are most likely to meet with co-owner approval and to ultimately succeed in their intended purpose.