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

**By Gregory J. Fioritto**

**Zelmanski, Danner & Fioritto, PLLC**

There is no question that the Great Recession hit the world of condominiums perhaps harder than any other sector of real estate. Condominium owners were hit with an unprecedented "double whammy," having to suffer not only the devastating loss of most (if not all) of the equity in their homes, but also the "aftershock" of strict new lending standards (impose by both the government and lenders themselves) that made the purchase of units at many condominiums almost impossible to finance.

One of the most notable changes in the landscape of the world of condominiums that resulted from these calamitous events was a significant rise in the number of investors looking to purchase units for use as rental properties. As condominium units became ever cheaper, investors found that the opportunities to purchase units "in bulk" for rental purposes increased greatly. However, the trend towards investor-ownership of condominiums eventually produced a strong backlash movement against rentals among many communities, for a variety of reasons.

This article (Part I of a two-part article on the topic of rentals) will examine the potential adverse consequences that can (and often do) arise in those condominium projects that have an inordinate amount of rentals. I will also discuss some of the key variables that a board should take into consideration before proposing any amendments to restrict rentals.

Part II of this article (to be published in the next edition of this Newsletter) will discuss the proper drafting of "grandfathering" and "undue hardship" exemptions in rental restriction amendments.

## I. Are Rentals a Problem?

It is worth noting that every condominium is unique, and no two condominiums will view the issue of rentals in exactly the same fashion. Those condominiums that already have a large number of landlord co-owners will, of course, be less likely to view rentals as constituting a problem meriting any significant board action (such as the proposal of a Bylaw amendment to limit rentals). By comparison, in those condominiums where there are fewer landlord co-owners, or in which the level of rentals has already caused concrete problems for co-owners (such as the inability to sell and/or finance units), the membership is much more likely to view rentals as a serious issue requiring immediate attention.

Looking at the issue from a more objective level, excessive rentals may be a problem for a condominium project for several different reasons. One of the biggest problems that co-owners at rental-heavy condominiums can encounter from a financial perspective is the inability to obtain mortgage financing for the purchase (or refinancing) of units.

One of the primary sources of funding for the purchase of homes in the U.S. is the "FHA" mortgage. "FHA" stands for the Federal Housing Administration, which is a federal agency that insures mortgages issued by private lenders. This insurance enables lenders to grant mortgages to borrowers on more lenient terms than most conventional mortgages (e.g., a down payment of only 3.5% is required for an FHA mortgage).

According to the Home Mortgage Disclosure Act (HMDA) Database, in 2013, 24% of all first mortgages were FHA-backed, and 10% of all mortgage refinances were FHA-backed. Although these

numbers have declined somewhat from their peak-recession highs (in 2009, 42% of all mortgages were FHA-backed), they still represent a significant portion of the mortgage market.

In 2010, the government did away with the "spot approval" process for FHA mortgages. Under the new rules, the entire condominium project must become "FHA certified" before any FHA-insured mortgages can be issued for the purchase or refinance of units at the condominium.

Currently, in order to be eligible for FHA certification, at least 50% of its units at the condominium must be "owner-occupied." Condominiums that are unable to meet this owner-occupancy requirement due to having an excessive number of rental units will be unable to obtain FHA certification.

Rental-heavy condominiums can also experience mortgage lending problems beyond those involved with FHA certification. Two federally-chartered corporations, the Federal National Mortgage Association ("FNMA" or "Fannie Mae") and the Federal Home Loan Mortgage Corporation ("FHLMC" or "Freddie Mac") are also key players in the residential mortgage market. These entities were originally created by the government to expand the secondary mortgage market for the larger purpose of increasing the number of lenders in the mortgage market (thus increasing home ownership generally). Although a full description of the history, function and purpose of these entities is beyond the scope of this article, the basic idea to grasp is that these entities make more money available to banks for mortgage lending through their purchase of mortgages from approved mortgage sellers on the secondary mortgage market, either for cash or in exchange for a "mortgage-backed security."

Fannie Mae and Freddie Mac have their own rules that determine whether or not a mortgage is acceptable for purchase on the secondary market; such acceptable mortgages are known as "conforming loans." The underwriting rules for Fannie Mae and Freddie Mac mortgages require that at least 51% of the units in a condominium project must be owner-occupied (though this rule only applies if the purchaser is an "investor"; if the purchaser is buying the unit for use as a primary or secondary residence, then this restriction does not apply).

Conventional lenders are also free to adopt stricter lending requirements in regard to owner-occupancy levels than those required by FHA, Fannie Mae and Freddie Mac if they so choose. Thus, board members should not assume that their condominium will have no mortgage lending issues as long as their condominium meets the minimum 50/51% owner-occupancy requirements mandated by FHA, Fannie Mae and Freddie Mac.

In addition to mortgage financing woes, rental-heavy condominiums may also experience rising insurance premiums. If a condominium has an excessive number of rentals, the association's insurer may rate the project as though it were an apartment complex. The premium that an insurer charges for insuring an apartment or rental complex can be significantly higher than the premium it would charge to insure a residential condominium.

Finally, there is the basic notion held by many condominium board members that tenants simply do not maintain their units to the same standard of care as co-owners do. Some board members also feel (perhaps rightly or wrongly, depending on the community) that tenants are more apt to cause disturbances in the condominium and/or to commit bylaw violations.

As a result of all of the above problems with renters (whether real or perceived, again, depending on the community), many condominium boards today are seeking out their attorneys to explore what options the association might have to limit rentals. One option that boards are choosing with increasing frequency as of late (in this practitioner's experience) is to amend the condominium's bylaws to tighten restrictions against rentals.

## II. Bylaw Amendments to Limit Rentals - How Far Can (or Should) the Board Go?

The Michigan Condominium Act, MCL § 559.212 (1) expressly provides that "the association of co-owners may amend the condominium documents as to the rental of condominium units or terms of occupancy." Thus, there is no question that the co-owners have the power under the Act to propose and adopt additional restrictions against the rental of units. However, there are a few caveats and variables that every board should know and carefully consider before attempting to propose a rental restriction bylaw amendment.

At the outset, the board should know (or at least have a fairly good idea, to the best of its ability) how many rental units exist in the condominium project currently. In most cases, the board's method of choice to limit rentals will be the adoption of a rental "cap" whereby no more than "x" units in the condominium may be rented out at any given time. However, the number that the board chooses for the cap should not be picked at random; rather, it should be set relatively close to the number of units that are already rented in the condominium. The reasons for this are fairly obvious - if a community currently consists of 40% rentals, for example, it is unlikely that the membership is going to approve a rental cap of 20% (even with extensive grandfathering). Also, before voting on the amendments, the membership likely will want to know the current level of rentals so that it can judge for itself if that level poses a problem for the community. For these reasons, the board should make a serious effort to ascertain the current level of rentals before proposing a rental amendment.

Although there is no "correct" answer to the question of exactly which number a board should choose in proposing a rental cap, there are other important factors (in addition to the number of existing rentals) that a board should evaluate when setting a rental cap number in such a bylaw amendment. Setting the cap anywhere above 50% would almost certainly be pointless if the goal is to prevent the problems that can arise with mortgage financing. If the cap is set anywhere above 30%, this will still allow landlord co-owners to control a significant block of units (and hence voting power) within the condominium, which is something that many communities want to avoid. Also keep in mind that the threshold for voting to amend a condominium's bylaws is 66 2/3% of eligible co-owners under the Act; thus, if landlord co-owners own close to 33% of the units in the condominium, they would likely be able to defeat any amendment proposals that might be adverse to their interests. The problems mentioned previously in this article regarding increasing insurance premiums and conventional mortgage lending can arise (at least in the author's experience) when the level of rentals in a condominium approaches anywhere between 20% to 30% of the units in the condominium (or higher). The board should carefully weigh all of the above considerations before it chooses a rental cap number to include in any amendment to the leasing restrictions contained in the condominium's bylaws.

The board must also be aware of the legal reality that, under the Act, any rental restriction amendments that are proposed (cap or otherwise) cannot "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." Pursuant to this language in the Act, all such existing written leases are expressly exempt from the effect of any new leasing restrictions that the Association might approve.

The Act does not specify (beyond the language contained in MCL § 559.212 (1)) to what extent (if any) a condominium association must further grandfather or exempt existing rental units from bylaw amendments that impose new rental restrictions or rental caps. Thus, it will be up to the individual community to determine the full extent to which existing rental units should be grandfathered from the new rental restrictions.

In Part II of this article, I will discuss the various ways that boards can draft grandfathering exemptions to rental restriction amendments and the considerations that underlie those drafting choices. I will also examine the viability of "undue hardship" exemptions and the role that they can play in a condominium association's adoption of a rental cap.