OFFICE CONDOMINIUMS: DEVELOPER OPPORTUNITIES, MARKETING AND STRUCTURING

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I. INTRODUCTION

The purpose of this article is to highlight the opportunities, marketing advantages and disadvantages as compared with leasing,[1] and important structuring aspects of office condominium documentation.[2] The perspective of the developer[3] and its counsel will be emphasized, although the concepts discussed in the article are generally of equal significance to the prospective purchaser of an office condominium unit and the purchaser's counsel. The article is not intended to be exhaustive,[4] and it assumes a working knowledge of basic principles of real property law in general and condominium law in particular. Tax matters are considered only in passing,[5] and matters concerning the developer's financing efforts are not considered.[6]

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[1]As a practical matter, there are no commercial developments of "cooperatives," because from a federal income tax standpoint the concept of a cooperative corporation is effectively limited to a predominantly residential building by the limitation under section 216 of the Internal Revenue Code concerning the pass-through of real estate taxes, interest and depreciation deductions. I.R.C. § 216; *see* Shapiro, *Commercial Condominiums: Tax Considerations for Unit Purchasers and the Association*, J. TAX. 204, 205 (October 1974).

[2]With respect to real property aspects, the principle reference will be to the provisions of the Illinois Condominium Property Act, ILL. REV. STAT. ch. 30, §§ 301–331 [hereinafter cited as Illinois Act]. Certain comparisons will be made with the Uniform Condominium Act (1980) [hereinafter cited as Uniform Act]. The Uniform Act is pending before the Illinois legislature, H.B. 1887. The author emphasizes the importance of a detailed review of all statutes, rules and regulations applicable to the development, *see Structuring Considerations, infra* at 6–7; *see also* ROHAN & RESKIN, *infra* note 4, ch. 23 (compares the general approaches and substantive provisions of the Uniform Act with the Model Condominium Code undertaken to be prepared by the Condominium Research Institute but not yet available to the public or the profession).

[3]*Developer* is used in a broad sense, to include the owner of an office building who awakens to the potential for condominium conversion of its building, in addition to the real estate professional.

[4]A good overview of the commercial condominium subject generally, with appendices that include a detailed bibliography, sample forms and citations to national condominium legislation, is contained in 1A P. ROHAN & M. RESKIN, CONDOMINIUM LAW AND PRACTICE [hereinafter cited as ROHAN & RESKIN]; *see also* Goldstein, Lipson, Rohan, Shapiro, *Commercial and Industrial Condominiums: An Overall Analysis*, 48 ST. JOHN'S L. REV. 817, 817 & n.1, 850 & nn.119 & 120 (1974).

[5]The writer emphasizes the need for cohesive tax-planning by a skilled tax practitioner, from the standpoint of the developer as well as the unit purchaser. Such planning is of particular importance given the relative lack of guidance from the Internal Revenue Service on various significant issues, such as the availability of capital gain treatment for gain on the sale by the developer of office condominium units.

[6]*See, e.g.*, ROHAN & RESKIN § 21.05 (discussion of types of financing and of lender's viewpoint, with a sample pro forma); P. Fass, "Commercial Condominiums Investment Considerations," *materials presented at Financing Real Estate During the Inflationary 80s* (ABA, 1981)

II. Opportunities

The primary opportunity for most developers is the realization of a substantially greater aggregate selling price from the sale of condominium units compared with that which would be realized if an office building were sold outright to a single purchaser.[7] The condominium may also be a desirable form of owning office building property in order to enable the developer to make partial dispositions of the property (whether to raise cash, or to diversify the developer's real estate holdings pursuant to a tax-free exchange under Section 1031). Thus, the developer could sell units to tenants at strategic times, such as the expiration of a major tenant's lease or in the context of a tenant's consideration of the making of substantial improvements, and could also grant options to purchase units to tenants in connection with lease extensions or renewals. Finally, there may be tax benefits from the conversion of an existing building to condominium status.[8]

III. Marketing: Advantages and Disadvantages

In marketing the office condominium, the developer must compare a purchase with a lease, from the perspective of the potential user. The condominium format offers significant advantages to the potential purchaser of an office unit over the leasing of comparable space over a long term such as ten or twenty years. The purchaser/unit owner will build equity in his unit over a period of time and will, in turn, lock in the appreciation in value of the office unit, including that attributable to improvements and additions

(review of securities law and other considerations potentially applicable to sales of condominiums); *see also* Rose, *Banks Should Look to the Futures*, 101 Fortune 185 (1981) (thought-provoking discussion of structuring fixed rate mortgage financing with the use of financial instrument hedging techniques).

[7]It has been observed that in the case of a conversion, a developer usually receives a total price as much as 50% more than if the developer sells the building as an undivided whole. *See* Note, *Tenant's Protection in Condominium Conversions: The New York Experience*, 48 St. John's L. Rev. 978, 982 & n.27 (1974).

[8]For example, an investment tax credit may be available for the cost of rehabilitating a building that was first "placed in service" at least 30 years prior to the commencement of the rehabilitation work or is a certified historic structure, I.R.C. § 46 (a) (2). In light of the recapture provisions, the credit is only of permanent value to the developer on its tax return if and to the extent that some of the condominium office units are owned by the developer for at least 3 years, although the credit may serve a valuable deferral function where the improvements are placed in service in one taxable year and disposed of in a subsequent taxable year but within 3 years of placement of the improvements in service. While the proposed regulations are silent as to condominiums, the owner of a unit probably may claim a ratable share of the credit for qualified rehabilitation expenditures by the developer, on a pass-through basis under the provisions of Prop. Reg. § 1.48–11 (c) (3) (iii), example (2), provided that the owner acquired the unit from the developer prior to the unit's being placed in service. Further, improvements to an individual condominium office unit by a unit purchaser should qualify for investment tax credit if the improvements otherwise qualify, I.R.C. § 48 (g) (1) (C).

In addition, another commentator has noted the potential for a unit owner to make a tax deductible contribution of one or more condominium units to a charity or to the owner's profit sharing or pension trust. Shapiro, *Commercial Condominiums: Significant Tax Benefits Possible if Properly Structured*, J. Tax 46 (July 1974).

to the unit made by the owner. In the case of some office condominiums with substantial common areas or facilities (such as stenographic pools, libraries, conference rooms and duplicating facilities), the condominium arrangement will permit the smaller space user to pool its investment with others to obtain an equity position that might otherwise be beyond its reach. Given the extraordinary increases in office rentals over recent years,[9] condominium ownership injects an element of stability and cost control that facilitates long-range budgeting and strategic planning. Thus, unit ownership eliminates the danger of nonrenewal of a lease for the space, or profiteering rent increases on renewal. Likewise, some element of what would otherwise be landlord profit may be eliminated from ongoing building maintenance charges.[10] A unit owner will generally have greater influence over the nature and frequency of maintenance activities in his unit and in the building common areas. Whether the unit owner will realize an income tax advantage (saving) or disadvantage (cost) in comparison with the rental of comparable space cannot be generalized and must be determined on the basis of a case-by-case analysis.[11]

The conventional wisdom among real estate professionals is that the principal disadvantage[12] is that the prospective purchaser of an office condominium unit may upon purchase be "locked in" to an ownership position, and not have the flexibility for expansion or contraction (including complete relocation) that a lessee might have.[13] However, it is submitted that this disadvantage is more apparent than real. Thus, where expansion is anticipated, both the unit purchaser and the tenant frequently acquire more space than required at the outset, and lease or sublease the excess space to third parties pending expansion. Significantly, however, office landlords are increasingly restrictive of the tenant's right to sublet,[14] and often are including provisions that prohibit a sublet,[15] that require the landlord's consent and allow the landlord to withhold its consent arbitrarily,[16] that give the landlord the right to cancel the lease as to the space proposed to be subleased,[17] or that require the tenant to pass through in whole or in part to the landlord any profit made by the tenant on the sublease rental.[18] In contrast, a right of first

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[9]For example, a quarterly office building survey for the period ended March 31, 1981 indicates that rents for prime downtown Chicago space have escalated 50% over rents in the quarter ended June, 1980. COLDWELL BANKER, OFFICE BUILDING REAL ESTATE DATA, CALIFORNIA, 1981.

[10]In a larger office building, the savings, if any, may be nominal, because the unit owners will presumably retain a professional managing agent, which will have its own profit element included in its charges.

[11]A good theoretical discussion of the elements on which to base an analysis is set forth in Shapiro, *Commercial Condominiums: Tax Considerations for Unit Purchasers and the Association*, *supra* note 1, at 204.

[12]*See* note 11, *supra*, and accompanying text.

[13]Unpublished office condominium market survey prepared by The Marling Group, Ltd., Northfield, Illinois (December 1980).

[14]*See generally* 1 M. FRIEDMAN, FRIEDMAN ON LEASES § 7.1 (1974 & Supp. 1980) [hereinafter cited as FRIEDMAN].

[15]*Id.* § 7.304a, 188 & nn.3 & 4.

[16]*Id.* § 7.304b.

[17]*Id.* § 7.1.

[18]*Id.*

refusal is typically the only restriction to which the condominium unit owner is subject. Indeed, a lease from the unit owner may be preferable to a sublease from the tenant, given the danger of termination of the sublease which would result from a termination by the landlord of the tenant's prime lease for default under the prime lease (absent the subtenant's successful negotiation of a nondisturbance agreement with the landlord).[19]

Where the need for expansion space is either unanticipated or sufficiently problematical that the unit owner or lessee does not acquire additional space, the unit owner may have an edge in flexibility over the tenant of comparable space if the condominium documents grant a right of first refusal[20] to the condominium's board of managers and, if not exercised by the board, to the owners of other units in the project. Although a tenant may be able to procure a similar right from its landlord, such a right is not commonly granted. And while some leases do include a clause giving the landlord the right to relocate the tenant in order to give the landlord greater flexibility in accommodating space needs of the tenant population, such rights are not commonplace, particularly where the tenant commits to a long-term lease involving substantial leasehold improvements.

In the case of contraction of space requirements (including relocation), the condominium unit owner is again in substantially the same position as the tenant of comparable space, because both may lease or sublease the unwanted space in whole or in part to others.[21] In addition, the unit owner may also sell part of its unit if the underlying condominium documents grant such a right.[22]

The other frequently cited disadvantage is that, unlike the tenant, the condominium unit purchaser must make an equity investment of 10–20 percent of the purchase price. The view of some is that the purchaser has thereby entered the real estate business, and that it could more profitably invest the funds in its principal business.[23] While the initial outlay may in fact temporarily tax the business' cash flow or resources, nevertheless the business may be acquiring better facilities and does have the stability of avoiding profit-taking rent increases and lease renewal problems. Moreover, the unit owner will have the benefit of the appreciation (net of taxes) at the time of the ultimate resale of the unit. While it is true that the resale market for office condominiums (and commercial condominiums generally) is largely untested, the same was once said for residential condominiums. The foregoing analysis makes clear the underlying viability of the office condominium concept.

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[19]*See* FRIEDMAN, *supra* note 14, at §§ 7.703–7.704.

[20]*See Structuring Considerations, infra* at 7–8.

[21]Indeed, as previously noted in the article, the lessee's ability to sublease may effectively be more limited than the unit owner's. *See* notes 14–18 and 20, *supra*, and accompanying text.

[22]In some projects, it may also be possible for the developer to divide the office building into many small units—the "boundaries" of which could be defined by the use of reference points such as structural bays or even a brass nail, rather than actual partitions—and to sell multiple units to each purchaser, thereby affording the purchaser the ability to sell off one or more integral units without any need to amend the declaration.

[23]*See* survey of The Marling Group, Ltd., *supra* note 13.

IV. STRUCTURING CONSIDERATIONS

In structuring and drafting the documents establishing an office condominium and governing its ongoing operation and governance, the residential orientation of most existing condominium statutes dictates that a threshold analysis be made of the origin and wording of the enabling provision of the applicable condominium statute to determine that such statute permits the creation of an office condominium. Moreover, given such residential orientation, the practitioner involved in his first commercial condominium transaction should read the statute anew, while bearing in mind the office uses to which the condominium project is to be put. The author also encourages review of the Uniform Act in order that the practitioner develop a sense of future trends in condominium law, particularly given some of the gaps and inappropriate concepts contained in many existing, residentially oriented statutes. In a state (such as Illinois) where the Uniform Act has not been adopted but its adoption may reasonably be anticipated, such review may also enable the practitioner to include provisions in the condominium instruments which better position the office condominium project to have the benefit of certain of the improvements in the Uniform Act as of its effective date.[24] An experienced title insurer may be able to provide some comfort, where the practitioner contemplates such anticipatory drafting.

In structuring the condominium documentation, consideration should be given to inclusion of a right of first refusal, which right presumably would be applicable to voluntary or involuntary sales and other forms of complete transfer, and to leases for a term (including options to extend or renew) in excess of a specified number of years, such as two or three years. Such right would be exercisable first by the board of managers of the condominium and perhaps, in the event of its failure to exercise, then by the other unit owners according to a prescribed system of priority. For example, other unit owners of space on the same floor might have first priority, then owners of space on the next higher floor, then the next lower floor, and so on, with the priority among owners on the same floor being determined according to a prescribed grid system derived from the structural layout of space on a floor. Consideration should be given as to whether or not the right should also be triggered by sales of stock or partnership interest in excess of a specified percentage of the corporation's or the partnership's shares outstanding, or by a merger or other form of business acquisition or combination, or an assignment of the beneficial interest in a title-holding land trust in a state like Illinois where the beneficial interest is personal property. While the breadth of the triggering provision should be tailored to the particular marketing concept of a given project, it is assumed that frequently a broad provision

[24]For example, as a threshold matter, the Uniform Act contemplates that certain of its more flexible provisions only apply where all of the units in the project are restricted to "non-residential use." *See, e.g.*, Uniform Act §§ 2–117(a) (amendment of declaration), 3–112(a) (conveyance or encumbrance of common elements), 3–113(i) (insurance) and 4–101(a) (applicability of Article 4 protections); *see also* Uniform Act § 1–102 and Comment thereto (applicability of Uniform Act to condominiums created prior to the Uniform Act's effective date).

should be avoided as a potential impediment to business management decisions by the unit owner and a likely impediment to unit sales.

The unit owner should have the right to make alterations[25] within a unit, or to combine[26] two or more units including common elements which serve only the units to be combined, so long as the same are in compliance with applicable building and fire codes and do not adversely affect the structure of the building. The unit owner should be obligated to pay any resulting increase in taxes. Likewise, the unit owner should have the right to subdivide a unit, although the owner's ability to sell, lease or otherwise transfer an interest in a newly created unit may be subject to rights of first refusal, as discussed above. In order for a right of first refusal system relating to transfers to operate, it may be necessary to condition the unit owner's ability to alter, combine or subdivide upon the use of demising walls coincident with grid boundaries.

Common expenses are typically required by condominium statutes to be charged to unit owners in proportion to their respective percentage interests in the condominium as set forth in the declaration.[27] While workable in the case of residential condominiums, this arrangement could prove troublesome in the context of an office condominium, where some unit owners may require facilities or services (such as cleaning or janitorial services, window washing and the like) not required by other owners. Where the need for such differential treatment is necessary, it may be preferable (albeit cumbersome) in light of most statutes for the unit owners requiring the service to make direct arrangements with the vendor, given the possibility that the validity of the condominium's creation might be called into question should the declaration allocate expenses differently from that required in the statute. Note should be taken of the applicable statutory provision concerning the priority of liens for common expenses.[28]

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[25]*See, e.g.*, Illinois Act, § 329; *compare* Uniform Act § 2–111.

[26]The Illinois Act contemplates that the condominium instruments may prohibit the combination or subdivision of units, or may subject the combination or subdivision of units to limitations provided by the condominium instruments. Illinois Act § 331; *compare* Uniform Act §§ 2–111(3), 2–112, 2–113. Similarly, the statutory provision concerning amendment to the condominium instruments has a precatory tone to it, and requires approval of the proposed amendment by a majority of the board of managers. Illinois Act § 331; *compare* Uniform Act § 2–117. Although such concepts may well be appropriate in a residential context, such restrictions and limitations fly in the face of the previously noted proposition that an important inducement to purchasing an office condominium is control over the unit and relief from disputes with landlords over alterations occasioned by changes in the needs of the unit owner's business or by the sale of the unit.

[27]*See, e.g.*, Illinois Act § 309; *compare* Uniform Act § 2–107(a) & Comments 1–4 thereto (common expense liabilities may be allocated according to any formula chosen by declarant and set forth in condominium instruments, without regard to the customary "value" standard, provided only that the formula may not discriminate in favor of units owned by declarant).

[28]Most statutes provide that such liens are superior to other liens, except tax liens and first (and in some cases, all) mortgages of record. While it has been argued with some force that a common expense lien might be considered similar to a municipal tax, and entitled to priority over all mortgages on the basis that "a mortgagee may have more to fear from inability of the condominium association to collect common expense charges from owners of other units, than from the loss of advantage when a common expense charge on its own mortgaged unit takes priority over its mortgage," ROHAN & RESKIN § 21.04[5], at 21–13, nonetheless the Uniform Act

Most condominium statutes contain high percentage vote requirements for the approval of various actions, such as the exercise of a right of first refusal by the board of managers[29] or the amendment of the declaration.[30] Such percentages have been the source of problems in the residential context, and it may readily be anticipated that they will prove to be a source of greater problems in a business context. The Uniform Act permits the use of any percentage in the case of an office condominium.[31]

Insurance matters bear careful review in the business context. In the case of property damage insurance, applicable provisions of condominium statutes generally require the board of managers to insure the condominium project for its full replacement value.[32] Some provisions permit a project to pass on to the individual unit owner increased premium charges attributable to improvements and betterments made by that owner, and the office condominium declaration should so provide. In addition, consideration should be given to authorizing and requiring the board of managers to maintain business interruption insurance covering the unit owners. With respect to liability insurance, the status of unit owners as tenants in common of the common areas (and, perhaps, as principals in relation to the condominium's agents and employees) under some condominium statutes makes it unclear whether or not a unit owner may sue the association or fellow unit owners in connection with an injury caused by a unit owner or owners. While the Uniform Act does authorize such a suit,[33] it does not speak to the concommitant issue of whether the association's liability insurance carrier must pay a judgment obtained by the unit owner. Given that typically unit owners are named as additional insureds on the association's master liability policy, the insurance principle that an insured generally cannot recover from his own liability carrier would appear to present a problem.[34] In contrast, the Illinois Act covers this gap by its provision that liability insurance maintained by the board shall cover claims of one or more insured parties (an owner) against other insured parties (the association).[35]

The Uniform Act does contain an insurance provision that could be of significant trouble to the association. Section 3–113(d)(3) would permit the property or liability coverage to authorize the carrier to disallow a claim where an agent (for example, a member of the board of managers, or one of the officers) or an employee engages in activity proscribed by the coverage

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adopts the compromise of affording the condominium association a priority to the extent of six-months' assessments based on the periodic budget. Uniform Act § 3–116(b) and Comment 2 thereto.

[29]*See, e.g.*, Illinois Act § 318(b).

[30]*See, e.g.*, Illinois Act § 327.

[31]Uniform Act § 2–117(a).

[32]*See, e.g.*, Illinois Act § 312; *compare* Uniform Act § 3–113 (not less than 80% of actual cash value, exclusive of land, excavations, foundations and other items normally excluded from property policies, required for the residential condominium; such requirements may be varied or waived in the condominium in which all units are restricted to nonresidential use).

[33]Uniform Act § 3–111.

[34]Presumably curable by inclusion of an appropriate provision in the declaration, Uniform Act § 3–113(i).

[35]Illinois Act § 312.

within the scope of his agency or employment. The Illinois Act[36] and most condominium instruments currently in use negate any right in the carrier to disallow such a claim. However, the Uniform Act does give the association the flexibility to vary or waive the insurance coverage requirements of the Act,[37] affording in general greater flexibility to the office condominium and in particular the opportunity to include an express provision in the declaration that would prevent such disallowance.

The typical statutory provisions governing substantial destruction of a condominium project are cumbersome and imprecise. Thus, the typical statute demands a high percentage vote to authorize rebuilding after a major casualty.[38] Moreover, if the condominium is not to be rebuilt, most condominium statutes provide that the insurance proceeds as well as the proceeds from any sale of the project are to be divided according to the undivided percentage interest of each unit owner, thereby potentially visiting an injustice on the unit owner that has expanded a substantial amount to improve its space. The Uniform Act allows greater flexibility to the practitioner drafting office condominium documentation.[39]

Finally, the draftsman should consider inclusion of detailed provisions concerning procedural and substantive aspects of eminent domain, given that most condominium statutes (including the Illinois Act) are silent on the subject. Absent statutory provisions or declaration provisions on eminent domain, a noted commentator has suggested that the courts are likely to treat a condemnation case as being governed by the statutory provisions concerning destruction of the condominium, an unintended and inappropriate application.[40] Indeed, it is submitted that the eminent domain provision of the Uniform Act leaves gaps to be filled by the careful draftsman, such as authorizing the board of managers to represent the interests of the owners in the common elements.[41]

V. CONCLUSION

The office condominium represents a timely opportunity for the developer. Likewise, the concept presents significant advantages to the user of space over the leasing of comparable space, particularly in light of extraordinary increases in office rentals and the largely illusory nature of the "lock-in" historically argued to be suffered by the purchaser of the office condominium units. While most first generation condominium statutes (and even the Uniform Act in certain respects) present significant gaps as well as certain barriers to the optimum documentation of the office condominium project, careful draftsmanship will overcome most problems, and the re-

[36]Illinois Act § 312.

[37]Uniform Act § 3–113(i).

[38]The Illinois Act requires unanimous approval to reconstruct if the insurance proceeds are insufficient to reconstruct, except where fewer than one-half of the units are rendered "uninhabitable," in which latter event the approval of three-quarters of the owners voting at a meeting is required. Illinois Act § 314.

[39]*See* Uniform Act § 3–113(i).

[40]ROHAN & RESKIN, *supra* note 4, § 21.04[13], at 21–16.

[41]*See generally* 2 P. NICHOLS, THE LAW OF EMINENT DOMAIN § 5.3[5] (1976).

maining risk should be more than outweighed by the potential rewards for developers and purchasers alike.