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Jack M. Knight

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# INCORPORATION OF CONDOMINIUM COMMON AREAS? AN ALTERNATIVE

JACK M. KNIGHT†

## INTRODUCTION

To many students and practitioners, the laws relating to real property are sterile and devoid of contemporary interest. The overriding necessity for certainty and predictability in this area of the law seems to stifle legal initiative and innovation. However, one recent concept in the field of real property—the condominium—has certainly developed contrary to this perceived stagnation. Although admittedly not a completely modern concept, with roots at least in the Roman<sup>1</sup> if not Babylonian era,<sup>2</sup> seldom has a property development sparked so much interest among legal commentators as has the condominium in the last ten years.<sup>3</sup>

The condominium has been heralded as a mode of ownership usable for many purposes—from housing for low-income urban dwellers,<sup>4</sup> to

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†Member, North Carolina Bar. Associate, Fleming, Robinson & Bradshaw, P.A., Charlotte, North Carolina.

<sup>1</sup>D. CLURMAN & E. HEBARD, *CONDOMINIUMS AND COOPERATIVES* 2 (1970).

<sup>2</sup>Galton, *Condominiums: The Experience of the Past Decade*, 66 *THE BRIEF—PHI DELTA PHI QUARTERLY* 91 (1971).

<sup>3</sup>An exhaustive bibliography is contained in P. ROHAN & M. RESKIN, *CONDOMINIUM LAW AND PRACTICE FORMS* Appendix A (1969) [hereinafter cited as ROHAN & RESKIN]. Two recent symposia are also illustrative of the concern in the area: 2 *CONN. L. REV.* 1-60 (1969) and 1970 *U. ILL. L.F.* 157-271. Similarly, a Practising Law Institute transcript contains valuable information on the condominium form of ownership. *PLI, COOPERATIVES AND CONDOMINIUMS* (Real Estate Law & Practice Transcript Series No. 4, 1969) [hereinafter cited as *PLI Transcript*]. Seldom has such enthusiasm been evident regarding a legal concept. For example, one commentator has suggested that “[i]t is not presumptuous to suppose that the condominium form and its variants will shortly make the other forms of multiple ownership completely obsolete.” Ellman, *Fundamentals of Condominiums and Some Insurance Problems*, 1963 *INS. L.J.* 733.

Although the initial market acceptance of condominiums was limited to states with high population densities and high land costs such as California, Hawaii, Illinois, and New York, a recent market survey indicated that the condominium will find excellent or good acceptance in seventy-four percent of the nation's fifty major housing markets. Becker, *A Marketing Primer for Condominiums and Cooperatives*, 1 *REAL ESTATE REV.* 61, 62 (1971).

<sup>4</sup>Quirk, Wein, & Gomberg, *A Draft Program of Housing Reform—The Tenant Condominium*, 53 *CORNELL L. REV.* 361 (1968). *But see* Berger, *Home Ownership for Lower Income Families: The 1968 Housing Act's "Cruel Hoax,"* 2 *CONN. L. REV.* 30 (1969).

luxury vacation dwellings, to office and shopping centers.<sup>5</sup> Yet, one flaw exists in the medium which may slightly inhibit its optimum utilization. This deficiency concerns the potentially unlimited liability of a condominium owner for damages resulting from incidents in the common or jointly owned areas of the condominium. This article will examine the unique problems associated with the condominium form of ownership, summarize one suggested solution to these problems, analyze the shortcomings of this solution, and suggest an alternative to accomplish similar objectives.

## THE CONDOMINIUM IN GENERAL

### *Characteristics*

It is not the purpose of this article to cover exhaustively the procedures and details of the condominium mode of ownership since this has already been done by many commentators.<sup>6</sup> However, a brief discussion of the essential components of various condominium statutory schemes is helpful to establish a frame of reference as a prelude to a more detailed consideration of problem areas. The condominium form of ownership is unique in that it features two real property tenancies simultaneously. The owner holds title to a part of the property individually—for example, the individual apartment in a high-rise development—and other portions of the property jointly with the other tenants—for example, the halls and ground. This is a “hybrid” form of ownership, since it permits separate ownership of individual accommodations and joint ownership of common facilities in a single multi-unit project.<sup>7</sup> This method, commonly considered as a means of housing ownership, can be used for owning many other varieties of real property, including high-rise apartments, garden-type apartments, cluster houses, shopping centers, office buildings, professional office parks, and even marinas.<sup>8</sup>

The condominium in some instances can be created without special

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<sup>5</sup>Although most of the discussion of condominiums has focused upon residential projects, “It is in the area of commercial development that many commentators believe condominium will have its greatest growth.” ROHAN & RESKIN Intro-3. See also Berger, *Condominium: Shelter on a Statutory Foundation*, 63 COLUM. L. REV. 987, 997 (1963).

<sup>6</sup>See, e.g., ROHAN & RESKIN ch. 7.

<sup>7</sup>“A condominium regime presents a dichotomy of both separate ownership and co-ownership.” 4 R. POWELL, *THE LAW OF REAL PROPERTY* ¶ 633.20 (1968) [hereinafter cited as POWELL].

<sup>8</sup>Note, *Condominiums: A Reconciliation of Competing Interests?*, 18 VAND. L. REV. 1773, 1780 (1965).

legislation.<sup>9</sup> Nevertheless, all fifty states, given incentive by the National Housing Act of 1961,<sup>10</sup> have enacted specific condominium-enabling statutes.<sup>11</sup> Although there are variations in each state,<sup>12</sup> the statutory scheme normally requires the following elements: a declaration or master deed, which contains project-identifying information, plans, plats, descriptions of the individual units and "common areas," and rules regulating the rights and responsibilities of the individual owners *inter se*; documents, commonly bylaws, governing the association of unit owners and providing for any necessary common management of the property; and individual unit deeds, by which the individual unit and an undivided interest in the common areas are conveyed. The declaration defines the interest of each unit owner in the common areas<sup>13</sup>—such as the joint walls, roof, stairs, halls, grounds, elevators, parking areas, and mechanical equipment—and may provide for limited common areas that may be used by only a portion of the unit owners. The bylaws or similar documents for the governance of the owners' association normally regulate the usage of individual units, provide for controls over resales through a right of first refusal,<sup>14</sup> and delineate the unit owner's responsibility for expenses relating to the management and maintenance of the common areas.<sup>15</sup>

The primary advantage of the condominium is that the unit owner

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<sup>9</sup>ROHAN & RESKIN §§ 4.01-.02.

<sup>10</sup>Act of June 30, 1961, Pub. L. No. 87-70, § 234, 75 Stat. 160, *as amended*, 12 U.S.C. § 1715y (1970). The act permitted the Federal Housing Administration to insure loans for condominium projects and provided an incentive for the states to pass enabling legislation to assure that their residents could secure the benefit of the FHA program. D. CLURMAN & E. HEBARD, *supra* note 1, at 6. Condominium loan insurance coverage for veterans has recently been added by the Veterans Housing Act of 1970, 38 U.S.C. § 1810 (1970).

<sup>11</sup>Vermont was the last state to adopt a condominium statute. VT. STAT. ANN. tit. 27 §§ 1301-29 (Supp. 1971).

<sup>12</sup>For the complete text and a comparative analysis of the statutes of the other forty-nine states and Puerto Rico, a leader in this field, see 1 & 2 A. FERRER & K. STECHER, *LAW OF CONDOMINIUM* (1967).

<sup>13</sup>The percentage interest of each unit owner in the common area can be calculated in several ways, but the typical method gives the unit owner title to the percentage of the common elements that the value of his unit is of the value of the entire property. See ROHAN & RESKIN § 6.01[3].

<sup>14</sup>The right of first refusal allows the condominium owners to insist that each new owner be financially responsible, an important consideration because expenses for maintaining the common areas must be paid by all owners.

<sup>15</sup>The bylaws establish the procedure by which the owners may expend funds for the general maintenance of the project and also govern the usage to which a unit may be put. For example, it may be desirable to prohibit children under a specified age or pets.

individually owns his unit and an undivided portion of the common elements and is thus free to do as he pleases with this property,<sup>16</sup> within the restraints of the governing documents and the normal limitations of real property laws. The most frequently cited advantage flowing from this scheme is intangible—pride of ownership; an individual is assumed to have more interest in property in which he has an equity than in property in which he is merely a tenant under a lease.<sup>17</sup> There are also substantial tangible benefits. Since the individual owner's interest has all the normal incidents of real property, he can secure his own financing<sup>18</sup> and is not subject to the risk of co-owner default.<sup>19</sup> This independence is very significant upon resale because new financing can be secured without regard to the financial condition of the owners of the other units.<sup>20</sup> Generally, the unit owner is treated as a normal homeowner for tax purposes and, in computing his federal income tax, may deduct his property tax and the interest on his mortgage. He can also avoid being taxed on any gain upon resale under certain circumstances.<sup>21</sup> Frequently, the unit owner has the additional benefit of centralized management and care for common facilities, such as the lawn.<sup>22</sup>

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<sup>16</sup>Kane & Helms, *The Illinois Condominium Property Act*, 1970 U. ILL. L.F. 157, 158.

<sup>17</sup>Becker, *supra* note 3, at 63.

<sup>18</sup>The unit owner is free to pursue any financing plan he pleases. He can make whatever down payment he wishes, from a minimum of ten percent to a maximum of one hundred percent in a completely cash transaction. "[N]o form of real property ownership owes its growth and development to financing as does the condominium. . . . [T]he most important advantage of the condominium lies in its flexible financing arrangements. . . ." Vishny, *Financing the Condominium*, 1970 U. ILL. L.F. 181. See generally Wisner, *Financing the Condominium in New York: The Conventional Mortgage*, 31 ALBANY L. REV. 32 (1967).

<sup>19</sup>This is a major disadvantage of the ownership form against which the condominium is most frequently compared—the cooperative. In the stock cooperative, the tenant owns stock in the cooperative and is given a proprietary lease. His lease payment must be sufficient to cover his pro rata share of the expenses of project operation and any debt service. If one cotenant defaults, the other owners are not technically liable; however, if they do not pay the share of the defaulting party, their investment may be lost upon foreclosure of the entire project. See generally P. ROHAN & M. RESKIN, *COOPERATIVE HOUSING LAW AND PRACTICE* (1970).

<sup>20</sup>Vishny, *supra* note 18, at 181. This is also a significant advantage vis-a-vis the cooperative. Since the cooperative is covered by one single mortgage, each owner cannot negotiate a new mortgage for his portion. Instead, either he must finance the resale himself, or the buyer must attempt to obtain a personal loan by using the cooperative stock as collateral. Lenders are considerably more cautious in making such loans as compared to loans secured by realty, and this reluctance is normally reflected in increased interest rates and higher down payment requirements.

<sup>21</sup>INT. REV. CODE OF 1954, § 1034.

<sup>22</sup>This feature is significant since the condominium is often marketed as being "carefree." A large portion of existing condominiums have thus been purchased as second homes and for retirement housing. See ROHAN & RESKIN ch. 20.

### *Potential Problems*

If several unique problems associated with the condominium form of ownership can be resolved, its utility and desirability will be greatly enhanced. The first of these problems concerns the potentially unlimited liability of a unit owner for various claims arising from activities in the common or jointly owned areas. In the absence of a statutory limitation, each unit owner is jointly and severally liable for both tort and contract claims arising from incidents in the common elements.<sup>23</sup> This spectre of unlimited liability is of more than theoretical or hypothetical interest due to the many possible sources of such damage claims. These claims may arise from a failure to maintain properly the common elements, the negligence of personnel employed by the owners' association, a failure to carry adequate workmen's compensation insurance coverage on these employees, negligence in operating playgrounds and pools, and the violation of fire ordinances and building codes. In addition, the individual unit owner may face product liability claims for injuries caused by defective vending machines and miscellaneous exposure under theories such as nuisance.<sup>24</sup> This list is continually expanding. For example, the current trend toward imposing liability on landlords for foreseeable criminal acts committed by third parties against tenants<sup>25</sup> may forecast a similar trend in the area of condominiums; the owners' association, and thus indirectly the unit owner, may be liable for injuries caused by criminal acts on the premises as a result of the association's negligence. Of course, an individual homeowner may be liable for the incidents listed above if they occur on his property, and in that respect the condominium dweller is in no worse a position than the homeowner. However, the *scope* of liability is significantly increased for the condominium; the unit owner is potentially liable not only for accidents occurring on the grounds immediately outside his unit but also for incidents occurring outside any of the other units in the development, an area that may include many acres.

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<sup>23</sup>Rohan, *Perfecting the Condominium as a Housing Tool: Innovations in Tort Liability and Insurance*, 32 LAW & CONTEMP. PROB. 305 (1967). "In the absence of a statutory limitation, there appears to be no escape-proof method of insulating the unit owners . . . from unlimited liability resulting from the maintenance and operation of the structure." 4 POWELL ¶ 633.25 [2].

<sup>24</sup>Rohan, *supra* note 23, at 308-09.

<sup>25</sup>See, e.g., *Kline v. 1500 Mass. Ave. Apartment Corp.*, 439 F.2d 477 (D.C. Cir. 1970), noted in 1970 DUKE L.J. 1046.

Several partial solutions have been suggested or implemented to protect the unit owner from unlimited liability. A few states have attempted to limit the liability of a unit owner to his pro rata share of any adverse judgment rendered in litigation arising from an incident that occurred in the common area<sup>26</sup> or have at least required that a plaintiff first levy upon and exhaust the assets of the owners' association before bringing suit against a unit owner.<sup>27</sup> The success of such statutory provisions in insulating a unit owner from unlimited liability is questionable,<sup>28</sup> and, from a policy standpoint, it may be unwise to attempt to give the condominium owner such an advantage over the normal homeowner.<sup>29</sup> The existing alternative to statutory protection, and currently the only relatively secure way to obtain protection, is a comprehensive insurance program. Such a program has already been recommended by one knowledgeable commentator.<sup>30</sup> Although this method may be successful, it could provide false security because lapses in coverage and uninsured risks are always possible. Additionally, the cost of such a program could be substantial, especially in light of the condominium's relative uniqueness.

A second problem relating to condominiums has not yet become significant due to the newness of most of the existing developments. As a project grows older, substantial repairs and modifications to its physical plant will be necessary in order for the development to continue to be an attractive investment. Since the unit owner owns his unit in fee, he will be able to make whatever arrangements he desires, including a second mortgage, to finance improvements on his own unit. This flexibility, as was previously discussed, is one of the condominium's principal advantages. But improvements will also be required to refurbish the common areas and are likely to be extensive. These may involve im-

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<sup>26</sup>FLA. STAT. ANN. § 711.18 (1969); IDAHO CODE § 55-1515 (Supp. 1969); MASS. GEN. LAWS ch. 183A, § 13 (1969); MISS. CODE ANN. § 896-01 (Supp. 1970).

<sup>27</sup>ALASKA STAT. § 34.07.440 (Supp. 1970); N.C. GEN. STAT. § 47A-26 (1966); WASH. REV. CODE § 64.32.240 (Supp. 1966).

<sup>28</sup>See ROHAN & RESKIN § 10A.03[2]. The North Carolina statute, N.C. GEN. STAT. § 47A-26 (1966), and the Virginia statute, VA. CODE ANN. § 55-79.37(2) (1969), are especially vague on this matter.

<sup>29</sup>The typical homeowner would have unlimited tort liability for incidents occurring on his own grounds. Yet, under some of the statutes a condominium owner might be free from liability for incidents in the common areas adjoining his unit. See ROHAN & RESKIN § 10A.03[2].

<sup>30</sup>*Id.* § 10A.05[2][A]; Rohan, 32 LAW & CONTEMP. PROB., *supra* note 23, at 316; Rohan, *Disruption of the Condominium Venture: The Problem of Casualty Loss and Insurance*, 64 COLUM. L. REV. 1045, 1050 (1964).

provements of external areas that are subjected to large amounts of traffic and abuse from the elements and replacement of internal mechanical equipment, such as air conditioning and heating systems, that is relatively short-lived. Yet, the owners' association can probably raise capital only by assessments from the unit owners since the association itself owns no property on which to secure a mortgage loan.<sup>31</sup> This will either place a financial strain on individual owners or prevent needed improvements and repairs from being accomplished. Thus, a mechanism is needed to allow improvements to be financed on a continuing basis.

### A PROPOSED SOLUTION

A recent law review note,<sup>32</sup> after a thorough consideration of many of the problems facing condominiums, proposed an imaginative solution:

In order to limit the liability of the unit owners for injuries sustained in the use of the common areas or facilities, it is proposed that the condominium be established in such a way that the common elements would be owned and operated by a separate corporate entity.

. . . [E]ach unit owner would hold . . . a number of shares in the common element corporation equal to his share of the undivided interest in the common areas and facilities.

. . . If properly capitalized and managed, the common element corporation should effectively limit the unit owners' liability for torts arising out of the common areas and facilities to the value of the corporation's assets; namely the value of the common elements and any accumulated income from rental units.<sup>33</sup>

This scheme was distinguished from an organizational mode currently allowed under some enabling acts<sup>34</sup> whereby the owners' association may be incorporated.<sup>35</sup> In the latter, the corporate form is purely for the management of the development and, since title to the common area

<sup>31</sup>ROHAN & RESKIN Intro-6.

<sup>32</sup>Note, *Condominiums: Incorporation of the Common Elements—A Proposal*, 23 VAND. L. REV. 321 (1970) [hereinafter cited as *Condominium Proposal*].

<sup>33</sup>*Id.* at 329.

<sup>34</sup>Although the Note stated that only four states expressly permit the association to be incorporated, *id.* at 324 n.15, in fact, at least seven states permit incorporation of the owners' association. CONN. GEN. STAT. § 47-89 (Supp. 1971); FLA. STAT. ANN. § 711.12 (1969); IDAHO CODE § 55-1506 (Supp. 1969); IOWA CODE ANN. § 499B.2 (Supp. 1971); MASS. GEN. LAWS ch. 183A, § 8(i) (1969); N.J. STAT. ANN. § 46:8A-27 (Supp. 1971); N.C. GEN. STAT. § 47A-19(1) (1966).

<sup>35</sup>*Condominium Proposal* 330.



remains with the unit owners, the corporate form cannot insulate the owners from liability.<sup>36</sup> Precedent for the recommended scheme was found in British apartment practice, where common areas are sometimes retained by the developer and conveyed to a management company.<sup>37</sup>

Incorporation of the common elements is projected to have the following benefits:

1. Limited liability. The corporation, if properly formed, should relieve the unit owner of liability for torts in the common areas.
2. Elimination of several liability. There would be no problems of picking the proper party to sue, requiring contribution from a joint tortfeasor, or determining if a unit owner could himself sue the association.
3. Elimination of principal-agent status. The association would no longer be merely an agent for the owner since the corporation would manage its own property—the common elements.
4. Improved management. The corporation would have total responsibility for the common elements and would be better able to secure insurance and to accomplish other management functions.<sup>38</sup>

The incorporation proposal would also assist in providing a solution to the problem of financing repairs and capital improvements to the common elements.<sup>39</sup> Since the corporation would actually own the common areas in fee, it should be able to obtain a loan by mortgaging these assets as security. This seems completely appropriate, since the money obtained would be expended on the very assets being mortgaged.

The proposal recognizes that substantial statutory changes will be required before the common-element corporation can become viable. First, a provision should be added to the various enabling acts to provide explicitly for incorporation of the managing organization and to allow for the conveyance of the common elements to such a corporation.<sup>40</sup> Second, since existing statutes prohibit the separation of ownership of

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<sup>36</sup>"Incorporation of the association, or of a management group, will probably not change the result [of unlimited liability], since the corporate entity is still in fact the agent of the owner and liability can be predicated on the basis of undisclosed or partially disclosed principals if necessary." 4 POWELL ¶ 633.25[2]. Rohan, 32 LAW & CONTEMP. PROB. *supra* note 23, at 309.

<sup>37</sup>*Condominium Proposal* 329-30, citing 4 POWELL ¶ 633.5. See also Rohan, 64 COLUM. L. REV., *supra* note 30, at 1050 n.34.

<sup>38</sup>*Condominium Proposal* 352-53.

<sup>39</sup>See text at note 31 *supra*.

<sup>40</sup>*Condominium Proposal* 333. Of course, some states already provide for incorporation, and evidently no state explicitly prohibits this organizational form. See note 34 *supra*.

the common areas and the units,<sup>41</sup> an amendment would be required to permit the conveyance of the common areas to the corporation.<sup>42</sup> Third, state lien provisions should be modified so that liens for labor performed on the common areas can attach only to those areas rather than on the individual units.<sup>43</sup> Fourth, enabling acts would require modification to characterize the common-element corporation shares as real property, rather than intangible or personal property, in order to secure favorable federal tax treatment.<sup>44</sup> Finally, since the common elements would no longer be owned by the unit owners, provision should be made for applicable property tax assessments on the common areas to be made a liability of the corporation, rather than the unit owners.<sup>45</sup> Several other potential problems relating to federal income taxation and securities law were also raised,<sup>46</sup> but since these considerations are not unique to the incorporated condominium association, they will be discussed later.

#### CRITICISMS OF THE PROPOSAL

Although the proposal recognizes a valid need, it has two major flaws that detract from its value. The first of these relates to the financing potential of the condominium—a feature that has contributed substantially to the ownership scheme's success.<sup>47</sup> Under existing condominium legislation, mortgage financing is secured by the owner's interest in his individual unit and his undivided interest in the common area.<sup>48</sup> This can be done since the owner has the same quantum of rights in this property as he would have in any other parcel of real estate. However,

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<sup>41</sup>See FHA MODEL STATUTE FOR THE CREATION OF APARTMENT DWELLINGS § 6(b), reprinted in ROHAN & RESKIN App-25.

<sup>42</sup>*Condominium Proposal* 331. A related recommendation is to amend the various statutes to eliminate any prohibition against partition. This would be done "to permit ownership of the common elements through proportional participation in a corporation." *Id.* This rather incredible statement completely ignores the concept of the corporate entity. Although a stockholder may feel that he "owns" property when title is held by a corporation, such a concept has little legal foundation.

<sup>43</sup>*Id.* at 331-32.

<sup>44</sup>*Id.* at 332. This is perceived to be feasible because a cooperative's shares are explicitly treated as real property for federal tax purposes. INT. REV. CODE OF 1954, § 1034(f). However, in the absence of similar coverage in the Internal Revenue Code for the condominium, the Internal Revenue Service is certainly not bound to follow *state* laws in such matters.

<sup>45</sup>*Condominium Proposal* 332-33.

<sup>46</sup>*Id.* at 353-68. Basically, these issues were concerned with the imposition of corporate income tax on the corporation and with the applicability of federal and state securities laws.

<sup>47</sup>See notes 18-20 & accompanying text *supra*.

<sup>48</sup>See Kerr, *Problems of the Mortgage Lender*, 11 PRAC. LAW. 55 (1965).

such mortgage financing would no longer be feasible under the proposal. Since the common areas would be conveyed to the corporation, the owner could mortgage only the property interest in his individual unit. The maximum loan that could be obtained would be substantially lowered,<sup>49</sup> since the total value of the common elements could easily equal twenty-five to fifty percent of the total value of the project.<sup>50</sup> Possibly, another loan secured by the value of the stock owned in the common-element corporation might be obtained, but, as has already been pointed out, this is not a satisfactory substitute for traditional mortgage financing.<sup>51</sup> The corporation itself could probably obtain the necessary mortgage financing for the common-element property, and the debt-service expenses could be paid by the unit owners as part of their assessment for common expenses. However, this tends to make the condominium equivalent to the cooperative, with the concomitant difficulties in obtaining satisfactory refinancing upon resale. This substantial problem was not discussed in the proposal, suggesting that the author was not aware of its existence. In summary, since the implementation of the proposal would substantially lessen—if not completely eliminate—what many have considered to be the condominium's prime benefit, it cannot be recommended.

Another major shortcoming exists in the plan that would prevent its implementation even if it were beneficial. This difficulty results from the myriad of statutory modifications that would be required to implement the recommendation. These range from legislation allowing the shareholder to be deemed to "own" the common elements actually owned by the corporation<sup>52</sup> to a provision treating the corporate stock

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<sup>49</sup>One commentator has noted that many buyers do not take the maximum loan that can be made. Vishny, *supra* note 18, at 193. However, it must be remembered that a large percentage of the early developments were of the resort, luxury, or retirement variety where the buyers' financial status was such that they were able to make a down payment in excess of the minimum required.

<sup>50</sup>This would vary depending on the type of project and the amount of facilities in the common areas. In a high-rise project, the common areas might include all of the development except the internal partitions and plumbing.

<sup>51</sup>It might be argued that a sophisticated institutional investor should be willing to make a loan to be secured by both the unit owner's real property interest and his shares in the corporation. In support of this argument it might be pointed out that the Internal Revenue Service treats cooperative shares as real property, see note 44 *supra*, and thus it should be possible to convince mortgage bankers to treat the shares in the same manner. However, such an argument would ignore the realities of the current financing situation. If the condominium concept is to continue its current vitality, it must fit within the existing parameters required by financial institutions.

<sup>52</sup>See note 42 *supra*.

as real property.<sup>53</sup> It would be difficult to find a person in each of the fifty states who would be willing to draft, from such vague specifications, specific amendments for statutes that are already far from uniform. Convincing the various state legislatures to enact the many changes needed would be even more difficult, especially when many of the recommended modifications create internal inconsistencies. For example, the proposal would treat the corporate stock as real property for income taxation purposes, thus ignoring the corporation for one purpose while recognizing it for another, that is, insulating the shareholder from liability.<sup>54</sup> The proposal would create another inconsistency by levying property tax directly on the corporation although the property would be deemed to be owned by the shareholder. One cannot believe that such massive statutory surgery would ever be accomplished. Thus, the proposal is not feasible from either a practical or a theoretical standpoint.

#### AN ALTERNATIVE SOLUTION

The objectives of the incorporation proposal are certainly valid and merit further consideration. Fortunately, most of the benefits of the scheme can be achieved by a simpler and more feasible alternative. A corporation could be formed to administer the affairs of the condominium, and each unit owner could be issued shares in proportion to his interest in the common elements. Then, the entire common area would be *leased* to the corporation on a long-term basis. The corporation would make lease payments to the individual unit owners and in turn would charge each owner for the maintenance and management provided.

This proposal accomplishes the desired objectives—limiting liability<sup>55</sup> and enabling the financing of capital improvements to the common area<sup>56</sup>—and yet can probably be accomplished within the existing statutory framework. It thus meets the objection that the former proposal required an impossible amount of statutory changes. Unlike the prior proposal, however, the lease alternative also allows financing to be handled in the same manner as in a normal condominium—through individual unit mortgages. Since the unit owner would retain title to the

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<sup>53</sup>See note 44 & accompanying text *supra*.

<sup>54</sup>The stockholder is to be considered as owning the common areas to avoid non-partition and non-separation provisions. See *Condominium Proposal* 331.

<sup>55</sup>See text accompanying notes 60-66 *infra*.

<sup>56</sup>See text following note 66 *infra*.

common area, a conventional mortgage could be obtained so long as the lease was made subject to the mortgage.<sup>57</sup> Refinancing could also be handled satisfactorily; the purchaser would be obtaining full title to the individual unit and accompanying common elements, although the common area would be subject to a long-term lease.

This proposal is not completely unique, as commentators have previously recommended that a corporation be formed to manage the condominium.<sup>58</sup> Also, the leasing of property to the corporation by unit owners has been suggested;<sup>59</sup> however, these recommendations have primarily been concerned with the potential corporate tax liability of condominiums that lease portions of their common areas to commercial tenants. To this writer's knowledge, the corporation-lease scheme has not previously been recommended as a method of limiting a unit owner's liability.

### *Effect on Liability*

Under a properly drawn lease to a bona fide corporation, the unit owners should be insulated from liability arising from the common elements. If the organization is properly incorporated,<sup>60</sup> strictly follows corporate formalities in the conduct of its affairs, and is provided with reasonably adequate initial financing, it should not be considered a "sham."<sup>61</sup> The most compelling factor in determining whether the "corporate veil" can be "pierced" is the adequacy of the capitalization of

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<sup>57</sup>The mortgagee may even be willing to give the lessee corporation priority if certain other security devices are included in the lease and mortgage. Such devices might include a provision requiring the lessee to pay rentals directly to the mortgagee under certain circumstances. See generally N. PENNEY & R. BROUDE, *LAND FINANCING* 451-60 (1970); 2 POWELL § 242[3].

<sup>58</sup>Berger, *supra* note 4, at 1007-08; *Condominium Proposal* 321.

<sup>59</sup>Anderson, *Tax Aspects of Cooperative and Condominium Housing*, N.Y.U. 25TH INST. ON FED. TAX. 79, 97 (1967); Anderson, *Some Tax Aspects of the Condominium*, 1970 U. ILL. L.F. 230; Note, *Condominium and Cooperative Housing: Taxation by State and Federal Governments*, 21 U. FLA. L. REV. 529, 536 (1969).

<sup>60</sup>Depending on the laws of the state involved, the corporation may be created as a normal business corporation, a "close" corporation, or a non-profit corporation. Of course, if the development has commercial tenants in the common areas, the latter form may not be feasible.

<sup>61</sup>The general rule is that a corporation will be recognized and not disregarded. H. HENN, *LAW OF CORPORATIONS* § 146 (1970). See generally 1 F. O'NEAL, *CLOSE CORPORATIONS* § 1.09(a) (1971). Although a discussion of the disregard of "corporateness" is beyond the scope of this article, the issue usually arises when a dominant shareholder attempts to utilize the corporate form to avoid personal liability for his individual acts. Cf. Note, *Should Shareholders Be Personally Liable for the Torts of Their Corporation?*, 76 YALE L.J. 1190 (1967). This situation would not be present in any but the very smallest condominium project.

the organization.<sup>62</sup> Since the corporation would have substantial assets—the common area leasehold interest in addition to its initial contributed capital—it should survive this test.<sup>63</sup>

The lease should be drawn with the necessary exculpatory clauses disclaiming liability for all damages arising as a result of tort or contract actions.<sup>64</sup> Although exculpatory clauses may not be judicially favored in the normal landlord-tenant situation, they should certainly be upheld, in the absence of inequality of bargaining power,<sup>65</sup> in a commercial context.<sup>66</sup>

Of course, as was noted in the previous recommendation, a massive judgment against the corporation, not satisfiable from its assets, might effectively terminate the operation of the condominium by tying up the common elements.<sup>67</sup> This problem is more severe if the common elements are conveyed rather than leased to the corporation, since a properly drawn lease would provide the unit owners more protection from this situation than would an absolute conveyance.<sup>68</sup> In any case, this situation can exist under the normal condominium scheme as well and, on balance, is not a negative factor.<sup>69</sup> The major objective is still accomplished: the unit owner is protected from unlimited *personal* liability.

<sup>62</sup>Gillespie, *The Thin Corporate Line: Loss of Limited Liability Protection*, 45 N.D.L. REV. 363, 386 (1969).

<sup>63</sup>Additionally, the unit owner would probably make a contribution to the owners' association to provide working capital. The amount of capital required cannot be predicted in the abstract but will depend upon the size of the development and the scope of the activities of the corporation. This capital contribution should be sufficiently large "to meet the reasonably expected obligations and contingencies of the enterprise . . ." 1 F. O'NEAL, *supra* note 61, § 1.10.

<sup>64</sup>See generally 2 POWELL § 234[4].

<sup>65</sup>2 POWELL § 234[4] (Supp. 1970), citing *Midland Carpet Corp. v. Franklin Assoc. Properties*, 90 N.J. Super. 42, 216 A.2d 231 (App. Div. 1966).

<sup>66</sup>It is normal practice to shift all liability for repairs to the lessee in the long-term, commercial lease. 2 POWELL § 242[1].

<sup>67</sup>See *Condominium Proposal* 334 n.45.

<sup>68</sup>The lease should be made contingent on the common element corporation or its assigns continuing to pay the rental payments to the unit owners and continuing to provide the various services and facilities to the unit owners. On default, the property would return to the unit owners and the corporation would drop out of the picture as far as the unit owners were concerned. This capability would probably not be available if the common elements were conveyed rather than leased to the corporation because of the general disfavor toward restraints on alienation.

<sup>69</sup>Even if the common elements are tied up by a massive judgment, the unit owner still has investment in the unit that cannot be reached by a judgment creditor of the corporation as it could be reached in a normal condominium. Admittedly, the value of the unit under these circumstances is speculative, and under some circumstances a particular unit owner might be better protected and the condominium might better be able to continue operation in the normal condominium than in

### *Effect on Financing*

As has previously been mentioned, the unit owner's financing alternatives are equivalent to those he enjoys in the normal, non-corporate condominium. The only precaution necessary is to draft the common element lease carefully, giving special consideration to mortgage financing to assure that the lease terms will be satisfactory to the financier. For financing capital improvements to the common areas, the long-term lease should have the same utility as a mortgage device as does a fee interest.

### *Implementation*

*Legislative Modifications.* Unlike the proposal that recommended conveying the common elements to the corporation, the lease alternative appears to require no statutory changes. No provision would be required to allow separation of the common elements from the units,<sup>70</sup> since the lease does not operate as a separation as would a conveyance by deed. Nor would it be necessary to provide for assessment of taxes directly on the corporation;<sup>71</sup> the unit owner himself should have no problem in continuing to deduct these taxes for federal income tax purposes because he still *owns* the common elements. Moreover, it would not be necessary to attempt to characterize the stock in the corporation as real property,<sup>72</sup> because the underlying fee interest would still belong to the unit owner and could be freely conveyed by him. Finally, specific approval to utilize the corporate form to manage the common area does not appear essential since there are no state statutes forbidding such an arrangement.<sup>73</sup>

Under the lease alternative the status of a lien placed on the common elements<sup>74</sup> could admittedly be clarified by statutory amendment,

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the corporate form of organization. This would result if a unit owner who is financially able to satisfy a substantial judgment personally is levied upon for debts arising out of the operation of the common areas and thereby "saves" the entire condominium. However, even this advantage does not exist under a properly drawn lease and disappears when the condominium as a whole is considered rather than an individual unit owner.

<sup>70</sup>*Condominium Proposal* 331.

<sup>71</sup>*Id.* at 332-33, 355-56.

<sup>72</sup>*Id.* at 332.

<sup>73</sup>*Id.* at 333. *But see* PLI Transcript, *supra* note 3, at 369 for the New York use of "association."

<sup>74</sup>Most statutes were patterned after the FHA Model Act, *supra* note 41, and section 9(b) of that Act does not permit liens on the common areas. Rather, any liens as a result of work on the

but a theory can be advanced whereby the unit owner is not subjected to such liens even without statutory change. The general rule is that a mechanic's lien can attach to the leasehold interest but not to the underlying fee.<sup>75</sup> Since the corporation would have only a leasehold interest that could be encumbered, arguably this is the only interest to which a lien could attach.

*Drafting Considerations.* In creating the corporation, it would be necessary to assure that the corporate stock could not be transferred except in conjunction with a unit deed and that it *must* be conveyed with the deed. This can be accomplished by provisions forbidding deed and stock separability in the project declaration, the unit deed, the corporate charter and bylaws, and on the face of the stock certificate.<sup>76</sup>

After the corporation has been created, it would be necessary to execute the lease of the common areas to the corporation. Implementing the common-element lease corporation for an existing condominium project would be somewhat cumbersome, since it would be necessary for *all* unit owners to execute a separate lease of their portion of the common areas to the corporation. Such unanimity may be difficult to achieve, depending upon the size of the project, but achieving it is the only method by which an existing development can proceed.<sup>77</sup>

During the formative stage of a condominium, the leasing of the common elements to the corporation can be accomplished in two ways. First, as has been discussed above, each unit owner could individually lease his portion of the common areas to the corporation. The necessary unanimity should not be difficult to achieve in the new project, because the project declaration and bylaws could require the unit owner to execute such a lease. In fact, the unit owner could actually appoint the owners' association as his agent to accomplish this task upon completion of the project. A second method would have the developer lease the

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common areas are placed on each unit. In the lease alternative proposal, it would naturally be better to ensure that the corporation, rather than the unit owner, is liable for these liens.

<sup>75</sup>Cases on this point are collected at 53 AM. JUR. 2D *Mechanics Liens* § 44 (1970). See also 49 AM. JUR. 2D *Landlord and Tenant* § 765 (1970).

<sup>76</sup>This should not be difficult, since inseparability is also required for a cooperative's proprietary lease and stock. D. CLURMAN & E. HEBARD, *supra* note 1, at 183. Additional limitations on this type of transfer could be provided in the documents creating the right of first refusal.

<sup>77</sup>Even if the condominium cannot lease all of its common areas to the corporation, it would be possible to subject a portion of such areas to the scheme. For example, if the owners' association were currently renting laundry facilities or restaurant space to commercial organizations, those portions of the common area could be leased to the corporation.



common elements to the corporation as soon as the project declaration is filed.<sup>78</sup> Operationally, this would be a simple solution, requiring only one lease. However, since the common elements are frequently defined only as the residue left after conveyance of the individual units,<sup>79</sup> such a lease may be difficult to draw with precision. This latter method is satisfactory—and perhaps preferable—if sufficient consideration is given to defining adequately the common elements to be subjected to the lease.

### *Other Considerations*

Several other potential problem areas, although of concern to all condominium projects,<sup>80</sup> must be given special attention when the corporate form is utilized. They concern federal income taxation and state and federal securities laws.

*Securities Laws.* Securities law questions potentially exist with the normal condominium, even if a corporation is not involved. In common understanding an interest in real estate is not considered a “security.” Yet, if an investment in real property for profit involves either a common enterprise or reliance on the efforts of another, a security is likely present in the form of an “investment contract.”<sup>81</sup> Under this definition, a security has been found in the sale of orange groves, cemetery lots, and vineyards.<sup>82</sup> If a security exists, there is potential for coverage by state and federal securities laws, in the absence of an exemption.

If a condominium unit is purchased simply to provide personal housing, there are probably no securities law implications since the profit motive is lacking. However, many condominiums are used as vacation homes, and projects frequently provide for the rental of an owner's unit when he is not personally in occupancy. If a condominium

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<sup>78</sup>This is somewhat analogous to the British practice mentioned previously. See note 37 *supra* & accompanying text. This may not be permitted when the developer retains the common areas and leases them to the condominium but should not be objectionable when done only as an interim measure before the units are conveyed to the owners. PLI Transcript 358.

<sup>79</sup>See *Condominium Proposal* 336-37.

<sup>80</sup>See, e.g., Anderson, *supra* note 59 (2 articles); Curry, *Tax Considerations of Condominiums*, 1970 TUL. TAX INST. 347; Rohan, *The Securities Law Implications of Condominium Marketing Programs Which Feature a Rental Agency or Rental Pool*, 2 CONN. L. REV. 1 (1969); Note, *Condominium—Tax Aspects of Ownership*, 18 VAND. L. REV. 1832 (1965).

<sup>81</sup>See I L. LOSS, SECURITIES REGULATION 491 (1961). See also Rohan, *Problems in the Condominium Field*, in PRACTISING LAW INSTITUTE, COOPERATIVES AND CONDOMINIUMS 317 (1969).

<sup>82</sup>I L. LOSS, *supra* note 81 at 490-91; see IV *id.* at 2503-04 (Supp. 1969).

is sold in conjunction with such a rental contract or "pool" arrangement, it may be subject to federal and state securities regulations.<sup>83</sup>

Similarly, the stock of the incorporated association should be in the same position as "securities" of the normal condominium for federal securities law purposes. If the project is not profit-motivated, it should not be subject to federal regulation, due either to Securities and Exchange Commission policy<sup>84</sup> or a specific rule exempting this type of organization.<sup>85</sup> If the condominium's major emphasis is on profit-making, through the use of rental pools or otherwise, registration is required unless an exemption from federal coverage can be utilized.<sup>86</sup>

The normal condominium may be exempted from state securities or "blue sky" laws but frequently will be subject to regulation by the state real estate regulatory agency.<sup>87</sup> However, the fact that a *corporation* is involved would not seem to create additional complications.

*Federal Taxation.* Even the normal, non-corporate condominium owners' association may be taxed as if it were a corporation if certain criteria are met.<sup>88</sup> The tax status of the normal condominium association

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<sup>83</sup>ROHAN & RESKIN § 18.03.

<sup>84</sup>*Condominium Proposal 364*; Clemson Properties, Inc., CCH FED. SEC. L. REP. 78,387 (SEC Aug. 13, 1971).

<sup>85</sup>*Cf.* SEC Securities Act Rule 235, 17 C.F.R. § 230.235 (1971). The previous recommendation indicated that "[t]he SEC has recently amended Rule 235, which had previously applied only to cooperatives, to exempt the traditional condominium regime from federal regulations." *Condominium Proposal 364*. How this rule was "amended" is not clear, because the current text is the same as was originally adopted in 1960. *Compare* 25 Fed. Reg. 12912 (1960), with 17 C.F.R. § 230.235 (1971). Nor is the coverage of the traditional condominium explained even though the rule specifically applies to *corporations*. Yet, the *policy* of this rule would appear to apply to the common area corporation.

<sup>86</sup>*See generally* ROHAN & RESKIN § 18.05; *Condominium Proposal 365-66*. There are generally two approaches: the intra-state exemption and the private offering. The intra-state exemption is difficult to comply with in all but the smallest projects, since a sale to a single non-resident can negate the entire exemption. The private-offering exemption appears attractive upon a shallow analysis, *id.*, since it would not involve a sale to the "public" but only to unit owners. However, this is not the proper test to determine if the private offering exemption is available. Rather, the true test is whether the purchasers are "Ralstonians," that is, sophisticated individuals with access to sufficient information to allow them to make knowledgeable investment evaluations. *SEC v. Ralston Purina Corp.*, 346 U.S. 119 (1953).

<sup>87</sup>*See Condominium Proposal 366-67. See also* I L. Loss, *supra* note 78, at 492-94.

<sup>88</sup>Treas. Reg. § 301.7701-2 (1960). According to the regulations, the factors to be considered include whether there are associates, a business objective, continuity of life, centralized management, limited liability, and free transferability. An organization may be treated as a corporation even if it does not have all of these characteristics—four of the six may be sufficient. *See* ROHAN & RESKIN § 15.05.

is not clear, and some commentators have advised incorporation to avoid the surprise of later being denominated a "corporation" by the Internal Revenue Service.<sup>89</sup> Thus, it appears that the corporation as proposed may not be treated substantially differently from the normal condominium organization.

The lease proposal does have significant advantages over the alternative of conveying the common elements to the corporation, because the unit owner in the former would clearly be able to deduct interest,<sup>90</sup> property taxes,<sup>91</sup> uninsured casualty losses,<sup>92</sup> and depreciation<sup>93</sup> associated with the common areas because he is still the *owner* of these areas. These deductions are probably not available under the original proposal<sup>94</sup> however, without amendment of the Internal Revenue Code.<sup>95</sup> The availability of the nonrecognition provision upon the sale of a residence<sup>96</sup> is not certain under either proposal, at least as to the portion of the sale proceeds that represents the value of the stock in the corporation.<sup>97</sup> Even if the nonrecognition provision is inapplicable, the unit owner would fare better under the lease alternative since his gain on the corporation's stock should be less.<sup>98</sup>

The unit owner would be receiving rental income from the common-area corporation that he would not be receiving if the common elements

<sup>89</sup>Note, 21 U. FLA. L. REV., *supra* note 59, at 536.

<sup>90</sup>INT. REV. CODE OF 1954, § 163(a).

<sup>91</sup>*Id.* § 164(a).

<sup>92</sup>*Id.* § 165(a).

<sup>93</sup>*Id.* § 167(a)(2). Whether the depreciation deduction is available also depends on whether the property is held for the "production of income." Although the purely residential portion of the condominium will not qualify under this requirement, the depreciation attributable to the common area should be deductible under the lease scheme since rental income will be received from the corporation and therefore the corporation will be "producing" income. See Anderson, N.Y.U. 25TH INST. ON FED. TAX., *supra* note 59, at 98.

<sup>94</sup>See generally *Condominium Proposal* 353-59. For example, the Note states: "There is no express authority [for deducting casualty losses, and] disallowance . . . could pose a substantial stumbling block." *Id.* at 358. "[T]he current Treasury Regulations seem to disallow the [property tax] deduction on the common elements to the unit owners." *Id.* at 356 (citations omitted).

<sup>95</sup>"Consequently, if the [property tax] deduction is to be allowed to the shareholder, an amendment to section 216 is required . . ." *Id.* at 357.

<sup>96</sup>INT. REV. CODE OF 1954, § 1034.

<sup>97</sup>The specific exemption available to cooperatives under section 1034(f) of the Internal Revenue Code may apply by analogy to the common-area corporation. *Condominium Proposal* 354.

<sup>98</sup>The value of the stock in the lease corporation will reflect only the value of the leasehold interest, while the stock value in a development under the original proposal would represent the worth of the entire fee of the common areas.

were conveyed to the corporation. With proper planning, the lease payments could be set to equal the various deductions—interest, taxes, and depreciation—available to the unit owner. Thus, his personal income taxes should not be increased.<sup>99</sup> Similarly, the corporation should balance its expenses—the rentals paid to the unit owners, maintenance expenses, and administrative costs—to avoid the imposition of the corporate tax.

One area of concern common to both the corporation and normal condominium involves the use of commercial rental income to defray the common area expenses. If a condominium receives rental revenue from commercial tenants who rent portions of the common areas, it would normally use the net income, after the payment of the direct expenses of the rental operation, to reduce the maintenance charges otherwise charged to the unit owner. The Internal Revenue Service may contend that this is not deductible by the corporation or owners' association as an ordinary and necessary business expense but instead is a constructive dividend to the shareholder.<sup>100</sup> Although no such case has been litigated involving a condominium, similar issues have received judicial attention in cases involving cooperative corporations. Whether the cooperative corporation can offset the rental income by deducting expenses associated with services to shareholders and thereby avoid taxation on this income has varied, depending upon which court of appeals decided the issue.<sup>101</sup> As had been forecast,<sup>102</sup> the Tax Reform Act of 1969 apparently closed this potential "loophole" by limiting the amount of deductible expenses to the amount of income received from the members.<sup>103</sup> If this provision is applicable to the condominium, and it apparently will be,<sup>104</sup>

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<sup>99</sup>Anderson, N.Y.U. 25TH INST. ON FED. TAX., *supra* note 59, at 98. See also Anderson, 1970 U. ILL. L.F., *supra* note 59, at 230.

<sup>100</sup>See ROHAN & RESKIN § 15.06[2]; *Condominium Proposal* 361-63.

<sup>101</sup>Compare *Bear Valley Mut. Water Co. v. Riddel*, 427 F.2d 713 (9th Cir. 1970) (per curiam), *aff'g* 283 F. Supp. 949 (C.D. Cal. 1968) and *Anaheim Union Water Co. v. Commissioner*, 321 F.2d 253 (9th Cir. 1963) (offset permitted), with *Chicago & W.I.R.R. v. Commissioner*, 303 F.2d 796 (7th Cir.), vacated, 310 F.2d 380 (7th Cir. 1962).

<sup>102</sup>ROHAN & RESKIN § 15.06[2].

<sup>103</sup>INT. REV. CODE OF 1954, § 277.

<sup>104</sup>The *Bear Valley* case indicated that the legislation reversed the theory espoused in *Anaheim*. 427 F.2d at 713 (dictum). However, the statute applies to a "social club or other membership organization which is operated primarily to furnish services or goods to members . . ." INT. REV. CODE OF 1954, § 277(a). It might be contended that the common-area corporation is not such a "membership organization," but this position would probably fail since ownership of a unit is a prerequisite to becoming a shareholder and, therefore, is equivalent to "membership."

the corporation will certainly be fully taxed on its profits from commercial rentals.

### CONCLUSION

As has been discussed, the creation of a corporation and the leasing of the common areas to such a corporation will have the beneficial effects of limiting the liability of unit owners and allowing capital improvements to be made without placing a financial burden on the owners. The lease alternative is clearly superior to the proposal that recommended conveying the common elements to the corporation. Whether the common-area lease corporation should be utilized in a given condominium project involves a consideration of several factors. As has been pointed out, the tax and securities law considerations are not markedly different with the corporation than with the normal condominium. Thus, the decision becomes one of balancing the increased legal fees<sup>105</sup> that might be involved in creating a corporation against the potential cost of unlimited liability, increased insurance expenses, and the intangible benefit of certainty. In the relatively small development, consisting of four to ten units, the traditional condominium organization may be satisfactory. In the larger project, however, the condominium lease corporation has substantial benefits, and its utilization is recommended.

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<sup>105</sup>Attorneys' fees are already substantial on a large project and may range from twenty to twenty-five thousand dollars. PLI Transcript 354.