

Withdrawal of Property From Condominium Property Act

With the sale of condominium units moving slowly and the rental market heating up, some investors and developers are electing to operate their condominium projects as rental properties. In fact, some properties that were once apartments, and then converted to condominiums, are now being reverted to their former uses.

Some operators of rental condominiums are finding that the administrative aspects of the condominium ownership structure are burdensome and add an unnecessary layer of compliance. Also, there is some feeling that for property tax purposes a single rental property may be more favorably assessed than an aggregation of condominium units. In this context, we have received some inquiries about how to “de-convert” a property, *i.e.*, withdraw it from the provisions of the Condominium Property Act (the “Act”).

Withdrawal of property from the Act is addressed in the Act itself. Section 16 of the Act (765 ILCS 605/16) permits all unit owners to withdraw property from the Act by recording an instrument to that effect. To be effective, however, the withdrawal must be agreed to by all encumbrancers whose liens affect any of the condominium property, by having their liens transferred to the undivided interests attributed to the owners whose units were so burdened. After withdrawal of the property from the Act, the property is deemed to be owned in common by all the owners, with each owner having the same percentage as previously owned by such owner in the common elements.

Thus, withdrawal of a property from the Act can be accomplished by recording a simple declaration to that effect, executed by all the unit owners and consented to by all the encumbrancers holding liens on the units. This, in and of itself, is straightforward, but - except in the case of a project that has only one unit owner, *e.g.*, a small property where all the units are owned by the original developer or by one investor or a newly developed (or converted) project where no units have yet been sold - the process raises some interesting questions. These include:

- 1. Who should join in the declaration for withdrawal?** Section 16 of the Act requires that the instrument withdrawing the property from the Act be executed by all unit owners and consented to by all encumbrancers. Therefore, it seems the only way to be certain that all necessary parties have been identified is to obtain a title insurance commitment or other report on title. There is also a related concern, namely, the ability of the owner or owners after withdrawal of the property from the Act to be able to convey an insurable title in the original (*i.e.*, pre-conversion) real estate to a future purchaser or lender. Therefore, it appears that involvement of a title company in the planning process for the withdrawal is essential.
- 2. What if all the unit owners will not agree to the withdrawal?** Section 16 of the Act states that the instrument that withdraws the property from the Act must be signed by all of the unit owners. Therefore, if there are unit owners who are not in favor of withdrawal the only solution may be for the unit owner or owners who want to withdraw the property from the Act to buy out the dissenting owners. This may involve more than a negotiation with the unit owners in question because in the current environment many units are “under water,” which means that negotiating the purchase of the unit may really amount to either agreeing to pay off the unit owner’s mortgage or working out a short sale with the mortgagee. Depending on the wording of the condominium declaration, there may be an “end run” around the problem, in that many declarations provide for a sale of the entire condominium property upon the vote of some percentage of the unit owners. In our experience, these range from about 75% to 90%. Usually the declaration also provides that, if the requisite vote occurs, all owners are bound to participate in the sale. Therefore, fewer than all the unit owners may be able to compel a sale of the property to a single entity, which can then file an instrument withdrawing it from the Act. This may be a particularly viable strategy for the developer of a project who has sold only a few units, such that the developer still owns or controls a large percentage of them.
- 3. Why would an encumbrancer agree to release its lien from a unit and transfer it to the unit owner’s undivided interest in the property?** This is a good question and one to which we do not have a ready answer. Section 16 requires that each encumbrancer of a unit do this in order for the instrument that withdraws the property from the Act to be effective. Yet it seems counterintuitive that a lender would release its lien on a unit - which is an identifiable property that (at least theoretically) can be sold in the event of the borrower’s default - and transfer it to an interest that is far less marketable. We think this means as a practical matter that withdrawal of property from the Act probably is feasible only in situations in which there is one lender, whose loan can be secured by a lien on the underlying

property after withdrawal, and/or where there is what amounts to a sale of the property and new financing is brought in to pay off the existing mortgages of the unit holders.

4. **If a property is withdrawn from the Act what is the resulting ownership structure?** Section 16 of the Act provides that after withdrawal of a property from the Act, the property is deemed to be owned in common by all the owners, with each owner having the same percentage as previously owned by such owner in the common elements. This presents its own set of legal and administrative issues. First, as tenants in common, all owners will be responsible for a share of the property's expenses and entitled to share in the property's income. Therefore, it probably will be necessary for the owners to enter into an agreement specifying their respective rights and obligations with respect to such things as income, expenses, management and use and occupancy of the property. For this reason, withdrawal of the property from the Act does not necessarily mean an end to the administrative aspects of owning and operating a multi-unit property. More significantly, all owners will have an interest in the title to the property, which has the potential to create title defects in cases of the death, divorce or insolvency of an owner and, in any event, may make it cumbersome or even impossible to engage in transactions involving the property. Many of the risks of common ownership can be addressed by requiring the owners to hold their interests in entities, such as LLC's, or for the owners to contribute their real estate interests to a commonly owned entity. These solutions, while generally effective, add yet another layer of complexity and administrative cost – exactly what the owners were trying to avoid by withdrawing the property from the Act.

Accordingly, in today's market, with stodgy condominium sales and dynamic apartment rental projects, it is important to understand all available legal opportunities to assist with meeting one's objectives. De-conversion of a condominium to an apartment rental property may provide an interesting alternative for investors, developers and owners; however, this process should be reviewed carefully on a case-by-case basis to ensure that such measures will be successful and advantageous.

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If you have any questions or would like assistance regarding the matters discussed above, please contact the editors of *Development News*:

Anne Garr, Esq.
312.360.6619
agarr@freebornpeters.com

Michael Moynihan, Esq.
312.360.6419
mmoynihan@freebornpeters.com

Dov Pinchot, Esq.
312.360.6579
dpinchot@freebornpeters.com

Richard Traub, Esq.
312.360.6605
rtraub@freebornpeters.com

Visit our website at: www.freebornpeters.com.