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Distressed Condominium Projects

Fractional interest sales might save the day

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The real estate meltdown of 2008-2009 has hit the New Jersey market with full force, particularly high priced, multifamily, condominium projects. Increased Fannie Mae and Freddie MAC requirements, high condominium fees, and high real property tax assessments have developers and sellers looking for alternate ways to make their products attractive and affordable, while maintaining pre-crash value to the seller. A possible solution suggested to these developers and sellers by often well-intentioned, but misinformed brokers, consultants, and buyers, is to offer fractional interests in these units. This strategy should be analyzed by experienced counsel and

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consultants possessing full information and knowledge about the benefits, burdens, and traps inherent in a fractional interest program.

A fractional ownership interest is just what it sounds like — the ownership of a fraction, often from 1/4 to 1/52, but more typically 1/8 or 1/13, of the whole fee interest in a specific piece of real property. Under many state laws and regulations, this type of interest falls squarely within the definition of “timeshare.” Unlike an ownership interest in the entity that holds fee title to the real property, such as a partnership interest or a member interest in a limited liability company, a fractional interest is a deeded interest in the real estate itself. Party A is the grantee in the deed for a 1/8 interest in Block 1, Lot 1. When Block 1, Lot 1, is a condominium unit, the same deed is used to transfer the fractional interest to Party A, but the complexities of ownership increase significantly.

The owner of a whole ownership condominium unit is subject to the condominium master deed and association bylaws, and must pay assessments to the condominium association for the maintenance and management of the exterior of the unit and the common elements of the condominium

project. When a fractional interest program is applied to a condominium unit, a second layer of management and costs are necessarily required to deal with internal unit issues. Owners of fractional interests cannot manage or change the property as they deem appropriate, but instead must comply with the requirements and procedures of the fractional interest program.

Because of this layer of complexity, a careful analysis of the market, legal, and management issues must be completed before this strategy is implemented. The list of considerations and issues is extensive, but there are several key issues that must be addressed.

Is a fractional program possible under the existing master deed for the condominium and local zoning regulations? Master deeds often contain limits on use of units and whether the unit can be occupied for reduced time periods. If so, the master deed may need to be amended to permit a fractional interest overlay even with respect to some, but not all, of the units. If any whole ownership units have already been conveyed to consumers, the ability to now subject some or all of the remaining units to a fractional interest program may require an amendment of the master deed, and the consent of the existing unit owners.

In addition, local zoning and existing land development approvals for the condominium project may prohibit “transient” use

of the condominium units. These laws and approvals should be reviewed very carefully to confirm whether they permit a fractional interest development of some or all of the condominium units.

Is the market a strong one for fractional interest sales? Unlike the sale of a whole unit, where the developer/seller will not retain any ownership rights or obligations in the unit, if the seller cannot sell 100 percent of the fractional interests, the developer/seller will remain obligated for any fractional interests not sold. Fractional interests are typically allocated based on weeks of usage, and in areas where there is not a strong, year-round demand for usage of the product, sales may be hampered by inadequate peak usage availability.

Lenders, today more than ever, are reluctant to finance whole ownership units when a fractional component exists. Fannie Mae lending guidelines have been tightened for common ownership properties, particularly with respect to the complexity and size of the potential interests in the project. Creating a fractional interest component in an existing condominium project will affect Fannie Mae approval for loans to fund initial purchase in the project. It also could impact refinance transactions for existing owners.

Marketing costs with fractional interest projects need to be carefully planned into the overall project budget. Many experienced fractional interest developers' budget between \$500,000 and \$1,000,000 for marketing expenses. The expenses are not relative to the size of the project, given that a typical fractional interest project involves only 15 to 25 units and between 60 and 100 deeded fractional interests in a quarter-share program, or 120 and 200 deeded fractional interests in a 1/8 share program. Planning and budgeting, therefore, become crucial to the project's success.

Is the developer/seller equipped to manage the fractional program? Unlike the condominium association, where management and control is transitioned to the owners over time, a fractional program acts and feels more like a timeshare program, where management and operations are managed by either the developer/seller or a strong timeshare manager. Because this type of management system includes the oversight of more services for the owners and occupants of the units, it can be more costly than the

traditional condominium association management. Fractional interest projects with larger interest components can also include a rental program, which involves additional management. Remember, except where the entire project is a fractional project, the fractional interest program does not take the place of the condominium program. It simply superimposes an additional layer of management and cost.

Does state law require the fractional interest program to have a separate consumer registration? Whether residential real estate must be registered with any state or local governmental agency is a function of state laws and the nature of the interest. In New Jersey, every in-state residential, for-sale condominium project must be registered with the Division of Codes and Standards in the New Jersey Department of Community Affairs under the New Jersey Planned Real Estate Development Full Disclosure Act (PREDFDA) (N.J.S.A. 45:22A-21, et seq. and N.J.A.C. 5:26-1.1, et seq.), although condominium projects where the total interests being conveyed are nine or fewer units can use a simplified disclosure and registration format. If the developer/seller subjects certain condominium units to a fractional interest program, these fractional interests may be required to be registered under the New Jersey Real Estate Sales Time Share Act (N.J.S.A. 45:15-16.50, et seq.), administered by the New Jersey Real Estate Commission (the Timeshare Act). Both PREDFDA and the Timeshare Act require the consumer to receive a public offering statement, which is different under each statute. If the entire condominium project will be sold in fractional interests, the project may be registered only under the Timeshare Act, reducing the disclosure requirement.

It should be noted that many states also require timeshare projects that are "marketed" to residents of the state but physically located out-of-state to be registered. "Marketing" can include print advertising, direct mailing and even Web site ads. For example, New Jersey, Pennsylvania and New York require registration of certain out-of-state timeshare projects that are marketed to residents in these states. Placing an ad in *The New York Times*, *Newark Star-Ledger* and *Philadelphia Inquirer* without restricting the ad to those editions delivered and/or sold within New Jersey could trigger a registration obligation in those states.

Can the project as designed accommodate the additional physical requirements of a fractional project? Fractional interest projects require additional management spaces (housekeeping closets, management areas, reservation desks and lobbies), amenities (active and passive recreation), and services (housekeeping, maintenance, and concierge services). An existing project may not be designed or be capable of redesign to provide these spaces and amenities. Increased labor and associated costs can often double and triple common charges applicable to a unit, over and above the condominium fees.

Be careful that you are clear about what you are marketing and to whom. There is a fine line between marketing real property interests and income producing property, the latter of which may trigger securities law registration. This is particularly true when a rental program is contemplated.

In the timeshare industry, exchange programs are often coupled with the real estate interest. The affiliation with these programs and managing them with your project may be crucial, particularly in areas where the project does not have a 12-month "high" season. A strong fractional interest project will have 40 or more weeks of high/strong shoulder season time. Exchange programs are often used to add value to the off-peak weeks included in the fractional interest.

It is important, however, to appreciate that even if the developer can address all of the physical and legal issues, consumer acceptance and marketing of the fractional product to consumers can be very difficult in the best economic times and will be even more challenging today. Developing a fractional interest project is difficult, time consuming, and costly for the experienced developer, considerations that are magnified when the fractional interest program is conceived "after the fact."

The answers to these questions are not simple or clear. It is critical, therefore, that before a developer/seller subjects all or any portion of a condominium project to a fractional interest program, all of these issues, including the costs and risks of taking this action and how, where and when to market the fractional interests, are analyzed by the developer/seller with the guidance of attorneys, managers, and marketing specialists knowledgeable and experienced in fractional interest projects. ■