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Martin Schwartz

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Phantom units: A hidden problem in distressed condominiums

by Martin A. Schwartz and Jeremy H. Segal

A byproduct of the recent real estate boom and bust is an outbreak of phantom condominium units, once a rare phenomenon. Investors or lenders considering an investment in a distressed condominium project with phantom units need to be attuned to potential problems.



Schwartz



Segal

Phantom units are possible because Florida law does not require that a condo unit be constructed before it is legally created. In fact, a "phantom unit" is a condominium unit that has been declared — created by the recording of the declaration of condominium — but not constructed. These unconstructed but declared units have little to no economic value

but can present myriad headaches to investors — including the need to pay assessments on each phantom unit.

Under Florida law, a condominium is created by recording a declaration of condominium in the public records of the county where the property is located. The declaration divides the property into two elements: condominium units and common elements. Phantom units may come into existence in two ways: first, through changes in construction unaccounted for in the recorded declaration of condominium or, second, through failure to construct phases of a project sub-

mitted to condominium ownership.

In the first instance, a developer may have contemplated building a 10-story condominium tower with five units per floor. At some point, the 10-story tower became a nine-story tower with only 45 units. In a rush to close sales in a deteriorating condo market, the developer recorded the original survey showing 50 units. The result is the creation of five phantom units.

Similarly, a developer planning a five-phase condominium consisting of five buildings containing 10 units each expects a quick sellout and submits all five phases to condominium ownership. However, with sales evaporating, only four buildings are constructed and 10 phantom units are created.

Since phantom units exist only on paper, bulk purchasers and lenders who are not familiar with a project's condominium documents often miss the existence of phantom units during their due diligence. A physical inspection of the above-described five-phase project may indicate unimproved land and four buildings. The unimproved land may be conceived of as an asset to sell for future development. But the land is burdened with 10 phantom units on which assessments must be paid as if the units were physically constructed. In essence, the land is more of a liability than an asset.

For example, Bilzin Sumberg has been involved in a project on the West Coast where the condominium was to consist of 224 units in seven buildings. Only one building was built when the full 224 units were submitted to condominium ownership. An unsuspecting owner who closed on one unit had no idea what he was

getting himself into. To compound the problem, there is also a question as to whether buyers of individual units, who have unknowingly bought into a project containing phantom units, will then be faced with paying an assessment fee based upon the total number of units, including phantom units, or on the actual number of built units on the property. Obviously the latter would substantially increase the buyer's liability.

In limited instances, some Florida courts have held that a condominium declaration's specific definition of a unit as an "individual private dwelling" excuses owners of unconstructed units from paying assessments because they cannot be lived in. However, most condominium declarations use the statutory definition of a unit and, in those instances, Florida courts have held that the owners of unconstructed units are responsible for the payment of assessments and are otherwise bound by the provisions of the declaration of condominium.

Once phantom units are created, it can be extremely difficult to eliminate them. Under Florida law, an amendment to a declaration of condominium changing the percentage by which a unit owner shares in the common expenses must be consented to by the owners of all affected units and the mortgagees of those units. An amendment eliminating phantom units would result in an increase in the percentage share of common expenses of every unit since with fewer units each unit's percentage of the whole would increase. The effect of this reallocation would increase the amount of individual assessments to cover the same expenses to operate the condominium.



It is unlikely that existing owners would agree to an amendment that would result in an increase in their assessments.

A recent change to the termination section of the Florida Condominium Act might provide a possible avenue for elimination of phantom units. A termination of a condominium regime requires approval by only 80 percent of the unit owners — as long as no more than 10 percent of unit owners oppose the termination. Termination is permitted as part of an amendment to and restatement of the existing condominium documents. Thus, by employing a termination it might be possible for a bulk owner of at least 80 percent of the units to eliminate phantom units. This possibility may be further facilitated by proposals to permit partial terminations of condominiums.

The best way to avoid the phantom unit problem is to ensure that competent counsel carefully reviews the recorded declaration of condominium and any amendments before any investor commits to a distressed condominium project.

Martin A. Schwartz is a partner in the real estate practice group of Bilzin Sumberg Baena Price & Axelrod in Miami. Schwartz specializes in commercial real estate, representing developers, lenders, landlords and tenants in Florida and New York. Jeremy H. Segal is an associate in the firm's real estate group, with a practice that includes acquisitions, sales, leasing, financing and condominium development.