Community Association Management Insider®

Helping You Run Your Condo or Homeowners Association Legally and Efficiently

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FEATURE

Tempted by the income you'd get from leasing an unused common area to a business? First consider all the legal and administrative hurdles.

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Use Caution When Considering Leasing Unused Common Space

By Andrea Brescia

With the rise of mixed-use spaces, the convenience—and financial benefit—of having a popular bakery or a national bank locked in for a 10-year, income-generating lease may seem like an attractive option for a common area that's going largely unused in your community. But proceed carefully: A steady stream of income from potentially high rents comes with a lot of advance planning and possible barriers that include issues with legality, zoning, governing document restrictions, and accommodations for persons with disabilities. If your association is looking for new and creative ways to generate more revenue, can it lease underappreciated common area space to a commercial tenant as a way to add convenience to your members and income for your association? And what do you need to know in order to consider this transaction?

We'll outline some of the major considerations below. There's a lot of groundwork to cover, and you must consider whether the time, effort, and cost it will take to potentially rezone the area are worth any financial gains you might expect to receive from leasing the space to a commercial tenant. We'll help you weigh the feasibility and avoid serious pitfalls when exploring the idea of leasing unused common areas to generate revenue and add a potentially convenient service to your association.

Check Your State Statutes

First and foremost, you must check your state law to confirm that what you're proposing is legal. "While alternative sources of revenue are always a popular topic, the leasing of common elements, at least under Florida law, may present some challenges," says Joseph E. Adams, a Florida attorney. "Although the condominium statute permits an association to lease common elements, a clause in the statute states that the common elements are to be made available to

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unit owners for the purposes intended," he says. So the next step in a state like Florida is to make a close examination of the governing documents to see how the common areas are intended to be used.

Many governing documents and covenants provide that the common areas are to be maintained for the use and benefit of the homeowners. Changing this purpose, even if the space isn't actually appreciated and used by the members, might not be as simple as it would appear, even if the proposed project garners favor from the membership and could be an alternative revenue stream for the association.

"It really depends on the laws of your particular state and what your governing documents provide," agrees New Jersey attorney David Byrne. He has come across associations changing the use of a common area, although not for commercial use. He cites an example where a condo association had extra space in the stairway that was connected to a line of units. The association sold 99-year leases to the space so that the unit owners could break down the walls and expand their units. But providing an additional asset to owners is an easier change to pull off than leasing to a commercial interest, which comes with a host of other considerations discussed below.

Review Your Governing Documents

In California, as in other states, the association is limited in what it can do with its common area by its governing documents. Sandra L. Gottlieb, a California

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attorney, notes that the articles of incorporation may limit what the community can do with its common area, and the CC&Rs could state that the board can use the common area for the benefit of all of the homeowners or third parties subject to homeowners' approval—typically by a minimum margin of 66 ⅔ percent. According to Gottlieb, unless your governing documents say otherwise, which many do, provisions in the articles of incorporation or in the director's duties may state that the common areas must be used for the benefit of the association and its members. In California, "changing the use of property in such a way as leasing it to a business could result in the taking of a benefit for some of the homeowners but not for all, which is a big no-no," she says.

In contrast, properties designated as mixed-use space leave common areas intact. "Lots of community associations are being built with mixed-use space that's not infringing on the common areas of the HOA," says Florida-based attorney Ellen Hirsch de Haan. But, she adds, if you have a piece of unused land that you want to build on for the purpose of leasing it to a business, that would be a material alteration, and a large percentage of the owners would need to approve it. "It's not very likely to happen," she cautions. "Owners often don't want the traffic of the public."

Hawaii attorney Richard Ekimoto says that in most residentially zoned properties in his state, you can have certain types of "residential ancillary" provisions to the residential use, such as a convenience store or something similar. And in many states it's possible to amend the governing documents to permit a use change, unless there's a state law that prevents that action. "If your state requires a designated purpose for common areas to be stated in the governing documents, then that at least raises the issue of whether or not you can deprive the owners of access to those areas," he says. "Renting out the rec center on a permanent lease would raise issues. A lot of use changes depend on the state statute and case law."

Anticipate Zoning Issues

The next step is to understand the work involved in properly designating the space for commercial use according to your local zoning or building codes, which can be a time-consuming process. Since the area is residentially zoned, this means converting the space for retail or business use in order to permit commercial operations either by getting a variance from the current zoning for a special use or rezoning the property altogether.

According to Adams, the zoning designations for most residential condominiums limit the use of the common elements to purposes ancillary to residential use, such as recreational, maintenance, and administrative facilities. "Use of common areas for a gift shop, for example, would probably require a special exception to the zoning laws in many cases," he says.

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Ensure ADA Compliance of Public Space

If you determine that you're within your legal rights and compliant with your governing documents to change the use of a common area, you need to consider new requirements that will be imposed on the actual space. By far, the biggest challenge to converting your space from association use to commercial use—which is public use—is bringing the area into compliance with the Americans with Disabilities Act (ADA). By designating this area as a public space, the association will need to make the property accessible to persons with disabilities.

"We worry every day about whether some action will trigger ADA compliance. When you change the structure, it could dramatically change the community and its requirements to comply with the ADA, which could have a significant financial impact," says Gottlieb, adding that the ADA generally doesn't apply to a homeowners association unless you're inviting the public into the facility. Once you've invited in a third party, you've opened the door. "A board would have to weigh—significantly—the income stream and other benefits that could arise from the proposed project against the potential liability that the association could be exposed to in now having to comply with ADA requirements," she says.

In addition to the space that would be designated for commercial use, the association would also have to provide ADA accommodation now for its common areas. Besides removing architectural barriers, there are other requirements to consider that go beyond mobility disabilities and include installing raised letter signage and water fountains for visually impaired persons, as well as appropriate accommodations for the hearing impaired. It's important to work with someone who has experience meeting ADA requirements: What looks acceptable to you might pose a hazard or be inaccessible to someone with a disability. You must now think about every area differently. For example, if you're providing parking for people to get to the business, the path along which the public will walk must be evaluated for compliance. In essence, every area that the public will now enter must be made accessible to persons with disabilities. Remember that even though the business is leasing a designated space, the public areas or common areas that the public will now use to reach that business remain under association control.

Consider Tax Implications

While a steady stream of income seems appealing, talk to your CPA about what the rental income would mean for your association. "The association should consider the tax implications of rental income, including whether the amount of non-assessment income would disqualify it from filing tax returns available only to associations, which have preferred tax structures," says Adams.

According to Ekimoto, most associations have non-membership income, and this type of income doesn't necessarily change the tax filing. But it does mean that you have to address the fact that you're generating income outside of assessments. Again, he stresses talking to a CPA. "At least in Hawaii, there would be some excise tax implications and income tax implications," he says.

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Insure the Association—and the Tenant

As the landlord, the association must require its tenants to have insurance and indemnify the association in the event of damage or loss. In the same way, the landlord, or association in this case, would also have its own insurance policy. But if an association decides to become a landlord and lease to a third party, the association should also buy insurance to cover the tenant as a precaution. Ekimoto warns that while you can contractually bind the tenant to have insurance and provide proof of insurance, it's still possible that the insurance could lapse for lack of payment, or that the coverage isn't sufficient, so you want to make sure that the association is protected.

Monitor Safety Concerns

In opening the association up to the public, the obvious consideration is ensuring the security of the members and property, especially if you have a gated community. "If you're going to have a business in the community, it changes the nature of traffic and who is coming into the property. You must consider security and liability issues," says Ekimoto.

Gather Your Team

Throughout this process, you'll need to gather your board, association attorney, and tax accountant, who will each have a role in determining if your project meets state law and is covered under your governing documents. After passing that gate, you'll need to investigate whether the project can be ADA compliant and financially sound, and gain the approval of your membership. If it does, your next call should be to a commercial real estate broker who will be able to guide you through the process of selecting a suitable tenant and creating a commercial lease—one that includes language that protects your association and members from unwanted nuisance. *(See "Risk Management: Find the Right Commercial Tenant for Your Association," in this issue.)*

Finally, if the obstacles of leasing your unused space to a commercial entity prove impossible in your state, or just financially daunting, consider other revenue streams like renting your rooftop to cellular towers, which can generate several thousand dollars a month, or creating rental storage units for homeowners in less trafficked common areas—which might avoid some of the trickier issues of leasing to a third party—and provide a sought-after amenity for owners who could use more space for that extra pair of skis. ♦

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RISK MANAGEMENT

Find the Right Commercial Tenant for Your Association

By Andrea Brescia

For associations that have designated commercial space, finding the right tenant is critical. While there are a lot of retail stores that provide convenience, not every commercial tenant is necessarily a good fit for your community.

The right tenant can be a revenue stream for your association, improve owner satisfaction, and create a vibrant hub. The wrong tenant can be a nuisance, making extra work for your board and creating a disruptive environment for your members. So how do you make sure that you lease your space to a business that will add to your community and not detract from it?

We spoke with David Restainer, managing director of commercial real estate at Douglas Elliman Real Estate in Miami, Fla., to get advice on finding the right tenant for your association. "In Miami, the financial district is the most dense neighborhood south of Manhattan, and our zoning requires that we have retail space in every condominium," says Restainer. "I've seen it done well, and I've seen it done incorrectly." At its most basic, he says, you must understand the type of business that would be complementary to your association and disallow everything else.

Solicit the Right Tenants

Set aside the excitement of the incoming revenue, and with your board, brainstorm a list of questions and potential concerns that need answering. What kind of tenant would you like for your association? Ultimately, you want a tenant that will match the identity of your association. Don't wait until you've found a potential tenant to ask questions. Gather your questions and use them as you speak to tenants that might align with the kind of business you'd like to see in the space.

"It's really important to control the tenant and understand what it's doing with its business," says Restainer. "Understand the retail space where its business operates, and the identity of your association, and ask yourself if the business matches that identity."

Also, you'll want to find out who is at the helm of the business, Restainer says. It's very important to have a seasoned operator, someone with entrepreneurial skills, who has had a proven track record of success. Ideally, you'll want a business with a previous location or multiple locations. Obviously, a tenant needs to be financially sound and have a good reputation within the community where it is currently or has previously operated. It's important to know the company

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making the proposal—get its business plan, and make a board field trip to another location of the business, if possible. In many cases, he says, you have to assess the potential tenant by feel as well as by gathering the facts.

PRACTICAL POINTER: Hire an experienced retail commercial broker who understands the marketplace. This person will be able to help you navigate the process, find the right tenant, and negotiate the terms of the lease. He or she should also be able to advise you on the competitive landscape and trends in the surrounding area, as well as on setting a price per square foot.

Find the Best Tenant—Not Necessarily the Highest Paying

Even if retail rates are skyrocketing around you, you'll want to consider the type of business that will best serve your association. Think of the commercial tenant as an amenity, which might also help you choose a tenant based on how it will fit into your association rather than price. For example, if you're hoping to get $100 per square foot, you still might consider a potential tenant that can afford only $75 per square foot if it would add an attractive amenity for the members—that is, you might rather have an upscale coffee shop paying $75 per square foot than a cigar shop paying $100 per square foot. Also, beware of trends like vape shops, the latest gourmet donut shops, etc. They may be here one day and gone the next. You want a tenant with staying power. Additionally, Restainer points out that you want to be friendly to the tenant in creating the terms—you want its business to succeed.

Negotiate the Lease

Since all parts of the lease are negotiable, it comes down to getting the right language in the lease that will protect the association and stipulate conditions like hours of operation, noise, signage and awnings, nuisance, access (so the access to the residential space is separate from the access to the commercial space), maintenance, utilities, and insurance. Here is where you need to work with an attorney with significant experience in retail commercial leases who will work in conjunction with your association attorney. Experienced brokers and attorneys will have seen it all and will know what type of language you need in the lease to best protect your interests.

Repairs or improvements to the space can also be included in the lease. But sometimes it pays for the association to shore up the space ahead of time to attract a tenant. Restainer cites an example of a building that had 1,000 condo units and unused space near its loading dock. The association was using the space, which was under the parking ramp, for storage. The board thought about ways to repurpose the space. It had enough room for a dog groomer or a wine store, but the space had no air conditioning or electricity. The association didn't want to spend the money to install the AC or electric, and against advice, spent time and money trying to find a tenant that would come in and take care of the

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installation. But the association couldn't find a tenant that was willing to take on those expenses not knowing the future profitability of the space. In the end, the association relented and made the upgrades. The space was then easily rented to a liquor store that's currently very successful. The moral: Sometimes a little expense upfront can secure the desired outcome and make it profitable for both parties.

Length of Lease

After all is said and done, you want long-term stability in your commercial space, especially if your association is in a desirable location. Restainer uses a bank branch as an example. If you have a branch that wants to open in your space, you'll want it to sign a five-year lease with three five-year options to renew, he says—having a bank as a tenant will ensure that the business is quiet, and the hours of operation, typically 9 a.m.–4 p.m., provide minimal interruption to residents. If you're located in a neighborhood that's changing, you might not be able to attract a tenant like a national bank, but you might consider leasing to a mom-and-pop store on short-term leases that you can replace with a more desirable long-term tenant when the time is ripe.

PRACTICAL POINTER: If the business has to make significant changes to the space, you'll want it to sign a five-year lease with a five-year option—and if the tenant doesn't stay for the full 10 years, your lease should require the tenant to reimburse the association for the costs of restoring the space or of the unamortized costs of improvements, if the improvements do not benefit the association in any way. If the unamortized costs of improvements do bring some benefit to the community, you'll need to consult an accountant to determine the amount that each party should be responsible for.

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RECENT COURT RULINGS

Recent Settlements Illustrate the High Cost of Fair Housing Complaints

Recent cases from California and New York—involving families with children and reasonable accommodation requests, respectively—highlight the importance of staff training in fair housing law in order to avoid discrimination complaints.

Families with children. A California condominium community recently had to pay more than $1.1 million to settle a class action lawsuit involving hundreds of current and former residents with children under 14, who lived there from 2011 through mid-2017.

At the center of the dispute was whether the community's "no sports play" rule violated federal and state fair housing law by discriminating against families with children. The complaint alleged that the homeowners association had, for many years, enforced the rule to prohibit any children under the age of 14 from being in the community's common areas without adult supervision and from engaging in any "sports activities" in the common areas.

The parties agreed to a settlement, which required the community to pay $800,000 to be divided among the roughly 334 class members, to permanently rescind all no-sports-play rules, and to refrain from adopting any rule that prohibits children from playing in common areas. The parties agreed to let a court decide whether and how much the community had to pay in attorney's fees to the families.

The court ruled that the community had to pay the attorneys representing the families nearly $300,000—down from the $450,000 originally requested, which the court found to be excessive [Lewis v. Silvertree Mohave Homeowners' Assn., Inc., November 2017].

Take a look at your rules to make sure they don't unduly limit children's activities in common areas. Rules restricting children from playing outside—or requiring adult supervision of children in common areas—could lead to accusations that you're treating families with children less favorably than adults living at the community.

Reasonable accommodation requests. A 1,118-unit condominium community in New York City recently agreed to pay $125,000 to settle allegations of housing discrimination for allegedly refusing to allow three residents with psychiatric disabilities to live with emotional support dogs in their units.

In its complaint, the Justice Department alleged that the community had a no-pet policy and generally required residents requesting reasonable accom-

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Recent Court Rulings

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modations for assistance animals to submit notarized statements from two doctors, including in some cases, detailed information about their disabilities, and sometimes required residents or their doctors to answer a series of follow-up questions. If requests were rejected, the community allegedly did not provide any reasons for the rejection.

According to the complaint, each of the residents applied for emotional support animals and all the requests were denied. The residents filed disability discrimination complaints with HUD, which conducted an investigation and issued a charge of discrimination.

Under the settlement, the community agreed to pay a total of $125,000 in damages and civil penalties and to adopt a new reasonable accommodation policy [United States v. Kips Bay Towers Condominium, Inc., February 2018].

Be careful when dealing with requests for assistance animals, one of the most common sources of fair housing trouble. Whatever your policy on pets, you must make an exception to allow an assistance animal when needed by an individual with a disability to fully use and enjoy the community.

If the member's disability isn't readily observable, then you may ask for reliable disability-related information that's necessary to verify that the member has a disability that qualifies under the Fair Housing Act—that is, a physical or mental impairment that substantially limits one or more major life activities—and has a disability-related need for the animal. But you can't ask members for access to medical records or medical providers—or for detailed or extensive documentation about their physical or mental impairments.

For more guidance on dealing with requests for assistance animals and other reasonable accommodations, you can download the one-hour on-demand webinar, *"When and How to Verify Disability After Receiving an Accommodation Request," here* or at *www.VendomeRealEstateMedia.com.* ♦