

**CONDOMINIUM ALTERNATIVES:  
MIXED AND NON-TRADITIONAL USES**

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**TABLE OF CONTENTS**

I. INTRODUCTION ..... 1

II. KEYS TO FLEXIBILITY ..... 1

    A. First Key: The Unit ..... 1

    B. Second Key: Developer Rights ..... 1

    C. Third Key: Phasing ..... 2

    D. Fourth Key: Nesting ..... 2

    E. Fifth Key: Commercial Carve-Outs ..... 2

III. FLEXIBILITY APPLIED: HORIZONTAL SEGREGATION ..... 2

    A. First Key: The Unit ..... 3

    B. Second and Third Keys: Developer Rights and Phasing ..... 3

    C. Regulator Reaction ..... 3

    D. Not Just for Mr. Big Builder ..... 4

IV. FLEXIBILITY APPLIED: VERTICAL SEGREGATION ..... 4

    A. First Key: The Unit ..... 4

    B. Second and Fourth Keys: Developer Rights and Nesting ..... 5

    C. Fifth Key: Commercial Carve-Outs ..... 5

V. CONCLUSION ..... 5



# CONDOMINIUM ALTERNATIVES: MIXED AND NON-TRADITIONAL USES

## I. INTRODUCTION

For the practitioner and layperson alike, the word “condominium” often conjures up the image of a mid or high rise attached residential project. A project similar to a traditional rental project with balconies, elevators, corridors, and common recreational facilities, the only real difference being that the living space is owned rather than rented. This image belies the power of the condominium form of ownership. The power lies in flexibility. The condominium form of ownership is not just for residential projects. It can be used to secure entitlements, accommodate seemingly incompatible uses, and solve tricky structural issues. It is one tool in the real estate toolbox. We hope this article helps you understand how we have used this tool in unexpected ways to solve problems and exploit opportunities.

## II. KEYS TO FLEXIBILITY

The utility of the condominium form of ownership flows from the flexibility incorporated into its enabling legislation. Specifically, in Texas, the Texas Uniform Condominium Act, Texas Property Code, Section 82.001 et seq. (the “TUCA”) governs condominium formation and governance. TUCA was adopted by the Texas legislature in 1993, effective on January 1, 1994.

### A. First Key: The Unit

In our view, the first and primary key that unlocks the power of the condominium form of ownership lies with how the condominium unit is defined. Perhaps the standard residential-centric image of a condominium flows, in part, from the regulatory system that preceded TUCA. Up until January 1, 1994, condominiums were established pursuant to Chapter 81 of the Texas Property Code, known as the “Texas Condominium Act.” The Texas Condominium Act is what is known as a “first generation” condominium statute, having been derived from a model condominium act proposed by the Federal Housing Administration in 1962.<sup>1</sup> First generation statutes are residential-centric and inflexible. Chapter 81 uses the term “apartment”, rather than “unit”, to define the portion of the project capable of separate ownership.<sup>2</sup> The definition of the

boundaries of an apartment contained within Chapter 81 are limited to the “interior surfaces of the apartment’s perimeter walls, floors, and ceilings”.<sup>3</sup> In effect, you are locked in a physical box under Chapter 81. The condominium world, through the lens of the first generation condominium statute, looks constrained, limited, and not very interesting. In simple terms, a box of Legos with one shape.

TUCA dispenses with the term “apartment” and instead uses the term “unit” to signify the area of separate ownership.<sup>4</sup> However, more importantly, TUCA blows up the box with seven words. Section 82.052 includes the standard walls, floors and ceilings definition, but the definition is preceded by the phrase “[e]xcept as otherwise provided by the declaration”. The walls, floors, and ceiling definition is operative only if the declaration does not define the unit in a different manner.

By breaking the physical box, TUCA allows the practitioner and developer to design a unit that meets the specific requirements of the project. If you can describe real property in three dimensions, you can create it.

### B. Second Key: Developer Rights

A second key to the power of the condominium form of ownership lies with the special rights which TUCA permits the developer to reserve to administer and complete the condominium project. These rights include the ability to complete all improvements, create units and common elements, subdivide units, add and withdraw land, and implement special marketing rights.<sup>5</sup> Importantly, through TUCA does require that the time period for the exercise of such rights be disclosed in the condominium declaration,<sup>6</sup> TUCA does not specify the time period.<sup>7</sup> The

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condominiums formed thereunder to residential use. Section 81.002(1) allows that an apartment may be for “residential or other use.”

<sup>3</sup> Tex. Prop. Code §81.105(a).

<sup>4</sup> Tex. Prop. Code §82.003(a)(23).

<sup>5</sup> Tex. Prop. Code §82.003(a)(12) and (22).

<sup>6</sup> Tex. Prop. Code §82.055(14) and (15).

<sup>7</sup> The rights referred to here are the rights associated with development, marketing and sale of the project. TUCA does place limits on the time period the developer can control appointment to the board of the condominium association. See Tex. Prop. Code §82.103. In addition, underwriting rules promulgated by HUD and FNMA limit the residential condominium developer’s right to expand the condominium to a period of 7 years after the condominium declaration is recorded.

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<sup>1</sup> Which was patterned after the Puerto Rico condominium act first adopted in 1958.

<sup>2</sup> Tex. Prop. Code §81.002(1). Use of the term “apartment” in Chapter 81 did not strictly limit

developer rights can also be partially assigned to sub-developers of the project.<sup>8</sup>

### C. Third Key: Phasing

A third key to power is phasing. Phasing means either adding additional land to an existing condominium regime, or converting land within an existing condominium regime into units.<sup>9</sup> Arguably, phasing under Chapter 81 was not possible since a deed conveying the apartment was required to include the specific “fractional or percentage interest in the condominium regime.”<sup>10</sup> In addition, and as discussed above with respect to TUCA, Chapter 81 had no express provision recognizing a developer’s rights to add land or convert existing land to units.

Phasing can include horizontal and vertical additions to the project. Horizontal phasing is similar to the annexation process associated with traditional master planned community development where new land phases are added as development of the project proceeds. However, vertical phasing is unique to the condominium form of ownership. With vertical phasing, the developer can reserve the right to create additional use areas for subsequent conveyance based on market conditions. In essence, a portion of the project above the existing development can be reserved for future opportunities.

### D. Fourth Key: Nesting

Nesting in the context of condominiums operates in a manner similar to the creation of master and subordinate communities in a non-condominium planned community. A nested condominium first requires the creation of master condominium units, which are traditional segregated by use. One or more of the master units is then submitted to a subordinate condominium declaration wherein the master units are further sub-divided into smaller components, or “sub-units”. Support for nesting is found in TUCA and the rights that a developer may reserve to further subdivide units.<sup>11</sup>

Nesting can be used to segregate cost and administrative obligations to a particular sub-set of users. For example, in a mixed-use project with residential and commercial components, it may be

desirable to encapsulate the residential units in their own condominium association. Encapsulation allows costs associated with a specific use to be assigned to such use, but probably more importantly, it vests administration with the specific use which frees the master developer from routine operational issues best handled by a subordinate regime. If designed appropriately, the master developer retains the necessary control and administration at the master level (e.g., architectural control, veto rights for certain actions) to ensure that the entire project is successful and achieves the developer’s vision.

### E. Fifth Key: Commercial Carve-Outs

One principal reason for the move from first generation condominium statutes was a lack of consumer protections built into these regulatory schemes.<sup>12</sup> However, TUCA recognizes that these protections are not always necessary or desirable for the non-residential project, i.e., the project where individual units will not be sold to the general public. The commercial carve-outs in TUCA allow the developer of the non-residential project to vary insurance requirements,<sup>13</sup> eliminate the requirement to deliver a condominium information statement to purchasers, modify the escrow requirements for deposits, and change certain obligations associated with completion of the development.<sup>14</sup>

## III. FLEXIBILITY APPLIED: HORIZONTAL SEGREGATION

Meet my client, Mr. Big Builder, or “BB” for short. BB has identified a tract of land that would be ideal for residential development. BB needs to build 140 homes to make the project work, but after discussing the project with his engineer he discovers:

- there are several nice trees on the property which are good for sales, but the rectilinear nature of lot size and placement required by the City land development ordinance means that several of these trees have to go;
- the City has a heritage tree ordinance, which means that BB will have to remove the trees

<sup>8</sup> See Tex. Prop. Code §82.104(a).

<sup>9</sup> The concept is sometimes separated by use of the terms “expandable” and “convertible”. “Expandable” means that additional land is added to an existing condominium declaration. “Convertible” means that land within an existing condominium declaration is converted from common elements to units. See Va. Code Ann. §55-79.41.

<sup>10</sup> Tex. Prop. Code §81.106(4).

<sup>11</sup> Tex. Prop. Code §82.063.

<sup>12</sup> See Prefatory Note, Uniform Condominium Act, National Conference of Commissioners on Uniform State Laws, <http://www.law.upenn.edu/bll/archives/ulc/fnact99/1980s/uca80.pdf>.

<sup>13</sup> Tex. Prop. Code §82.111(j).

<sup>14</sup> The “consumer protection” provisions are found in Subchapter D of Chapter 82 of the Texas Property Code. Tex. Prop. Code §82.151(a) allows the provisions in Subchapter D to be modified or waived by agreement.

and replace with similar size trees elsewhere on the tract which is cost prohibitive;

- the City has a minimum lot size requirement, BB was hoping to do smaller lots- that is what BB thinks the market wants.

As a result of these requirements, BB discovers he can only do 80 lots on the site. BB, after consulting with his engineer and sales force, decides he can do 145 lots if they were smaller lots with a more creative configuration. Something like this for some:



And something like this for a few others:



Should BB pass on this deal?

**A. First Key: The Unit.**

As discussed in Section II.A. of this article, we have the ability to define each of these “homesites” as a condominium unit in the condominium declaration. We are not constrained by any existing physical improvements. So how do we define the “homesites” in a manner to realize all the incidents of single family detached home ownership within the context of a condominium? We might define the boundaries of each condominium unit as follows:

- Lower Boundary: The horizontal plane corresponding to the finished grade of the land within the Unit as described and defined on the Condominium Map.<sup>15</sup>
- Upper Boundary: The horizontal plane parallel to and fifty feet (50’) above the lower boundary of the Unit.
- Lateral Boundaries: A plane located on each side of a Unit perpendicular to the lower and upper horizontal planes, from the lower boundary of the Unit to the upper boundary of the Unit.

<sup>15</sup> The condominium map is referred to as the condominium plat and plans under TUCA. The condominium plat and plans must be prepared in accordance with Tex. Prop. Code 82.059.

We would also be careful to include any improvements or components, which serve the homesite to the extent those improvements or components exclusively serve the unit.

**B. Second and Third Keys: Developer Rights and Phasing**

To realize BB’s goal of completing the project and responding to market conditions, we will not create all the units when the condominium declaration is initially recorded. We will not do this for two reasons: (i) BB’s plan, with respect to homesite configuration, may change over time and we would like to preserve the right to modify the size of the homesites based on market acceptance; and (ii) since the project may take more than three years, we do not want to pay assessments on units owned by BB but yet to be developed.<sup>16</sup> Instead, we will reserve the development rights to add land to the regime and create additional units.

**C. Regulator Reaction**

At first glance, it might seem that BB is subverting the City subdivision requirements. Neither the City, nor any other regulatory authority, can prevent BB from filing a condominium declaration. Section 82.051(d) of TUCA provides that “[a] county clerk shall, without prior approval from any other authority, record declarations and amendments to declarations in the real property records and record condominium plats and plans in the real property records or in books maintained for that purpose”. However, we do know that TUCA “does not affect or diminish the rights of municipalities and counties to approve plats of subdivisions and enforce building codes as may be authorized or required by law.”<sup>17</sup> If the City decides to regulate the project, and they will, we also know that the City cannot apply a rule or requirement that would “prohibit the condominium form of ownership or impose any requirement on a condominium that it would not impose on a physically identical development under a different form of ownership.”<sup>18</sup>

It has been our experience that if the property submitted to the condominium regime is a platted lot

<sup>16</sup> The developer has the option to subsidize the difference between operational expenses of the association and assessment revenue collected from non-developer owners, OR pay the assessments attributable to the developer owned units. Usually, the developer will elect to subsidize. However, the right to subsidize rather than pay assessments will expire three (3) years after the first conveyance of a unit. Tex. Prop. Code §82.112(b) and (c).

<sup>17</sup> Tex. Prop. Code. §82.051(e).

<sup>18</sup> Tex. Prop. Code. §82.006.

or benefits from a platting exemption, the city or county will regulate the project either through the site plan approval process or as an exemption to their subdivision ordinance. In either case, using the condominium form of ownership is a means to configure units in a manner that would otherwise be unavailable through the traditional platting process required by cities and counties to obtain approval of the subdivision of real property.

**D. Not Just for Mr. Big Builder**

The specific use, in BB’s case residential, is not as important for the purpose of horizontal segregation. The same approach can be been applied to commercial developments with separate pad sites that will be separately conveyed to end-users. In some circumstances, entitlements may be set for a particular development and those entitlements were determined when the developer intended to lease and otherwise operate the project. A different opportunity or circumstance has arisen and now the developer desires to separate or alienate all or a portion of the project. In other circumstances, the developer may need to segregate equity between different land areas of the project, may have different financing opportunities or requirements that necessitate segregation, or may elect to develop one use with other uses being developed by unrelated third parties.

**IV. FLEXIBILITY APPLIED: VERTICAL SEGREGATION**

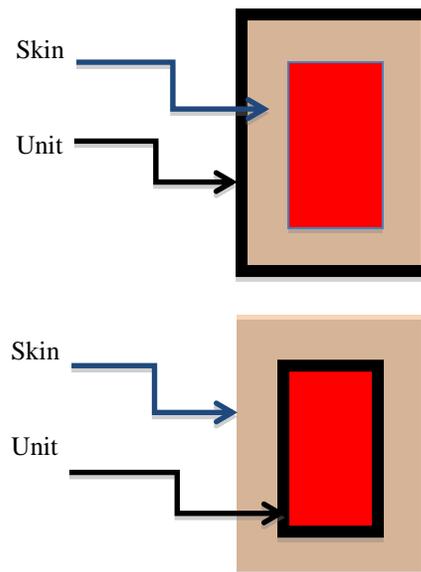
The true vertical mixed-use project may be a combination of vertical and horizontal development, but the project is “mixed” meaning that different uses co-exist within close proximity. Often the co-existence includes sharing of structural or mechanical components, or specific amenities such as parking or open space. Segregation of vertical ownership may be desirable for many reasons. Examples include: (i) segregation of ownership at the beginning of the project with owner-controlled specific purpose entities as a means to isolate liability or accommodate special financing arrangements;<sup>19</sup> (ii) segregation to allow components to be sold by the founding developer and developed by separate ownership groups; (iii) segregation where the founding developer elects to develop only a portion of the project with the remaining portions of the project being developed by unrelated parties; or (iv) segregation after completion to release equity.

**A. First Key: The Unit.**

Vertical segregation is more complicated in that different uses often share physical improvements. Particular care must be taken to accurately describe the unit boundaries. When describing vertical boundaries the default walls, floors and ceilings definition in Section 82.052 will seldom, if ever, adequately describe the unit in the modern mixed-use project. It should also be noted that TUCA does not require that units be contiguous so a specific single use located in different parts of the same project can constitute a single unit.

The practitioner must carefully review design and/or construction drawings when planning and drafting vertical use boundaries. Special care must be taken to draft demising wall boundaries to ensure that maintenance and insurance responsibility can clearly be determined after the fact.<sup>20</sup> The condominium plans will not include the level of detail necessary to “peel” back construction wall systems to determine responsibility.

Due to the flexibility afforded by TUCA, boundaries can encapsulate areas ordinarily considered to be common area and not usually included within unit boundaries. Here is a simple representation of the concept:

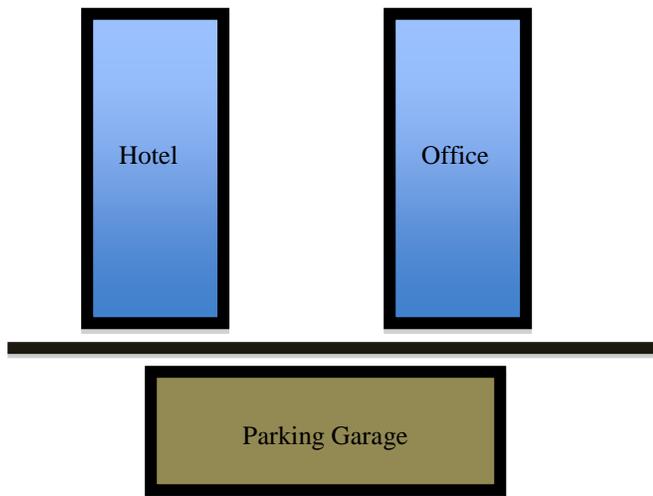


Why would you encapsulate exterior portions of a building? One reason would be if different owners are constructing different use components and, even though there may be shared structural components,

<sup>19</sup> In one recent application, vertical segregation was required due to HUD limits on the types of uses which could be financed with Section 108 funding.

<sup>20</sup> Except in rare cases, maintenance of an individual unit will be the responsibility of the unit owner and the condominium association will obtain insurance for the structure and unit (excluding improvements and betterments). For projects restricted to non-residential use, insurance for the unit, even if the project has horizontal boundaries, can be allocated to each unit owner. In the author’s experience this seldom makes sense.

there is a clear demarcation between each use. For example:



### B. Second and Fourth Keys: Developer Rights and Nesting

If the condominium form of ownership is initially used for the project, developer rights must be retained to accommodate completion of the project and changes in market conditions. As noted in Section I.B of this article, there is no specific time duration in TUCA for the exercise of such rights, but the duration of such rights must be set forth in the condominium declaration. In almost all circumstances, it would be prudent to at least reserve the right to nest the segregated unit. That is, the condominium declaration should accommodate submission of the segregated use unit to a subordinate condominium. Though TUCA allows the subdivision of units if the right is properly reserved, to accommodate nesting requires special provisions, namely a means to allocate common interest and expense allocations established in the superior declaration to any sub-units created under the subordinate document.

The more interesting circumstance is segregation of a single owner mixed-use project post-completion. As noted above, this may occur where the owner seeks to alienate a specific use to release capital. In such circumstances, and due to the fact that developer rights can be partially assigned, it is possible to structure developer rights in a manner that affords each owner a certain level of autonomy with respect to that owner's unit. For example, marketing rights, the right to allocate or redesign agreed-upon common areas, and the right to nest may be reserved and allocated to each owner. Parameters regarding the use and exercise of such rights can be agreed upon between each owner by separate instrument external to the condominium declaration.

### C. Fifth Key: Commercial Carve-Outs

TUCA and its commercial carve-outs can be particularly useful for segregating use in the non-residential project. As noted above, pursuant to Section 82.151(a), the consumer protection provisions in Subchapter D of Chapter 82 can be waived by agreement. Usually this is done in the purchase and sale agreement. In most circumstances, the waiver is used to avoid the requirement that a condominium information statement be delivered which removes the six day right of recession pursuant to Section 82.156(b). However, frequently overlooked is the fact that Section 82.158 is within Subchapter D. Section 82.158 requires that all deposits made by a purchaser associated with the purchase of a unit be held in an escrow account administered by a title company and not delivered to the seller until closing or the purchaser's default under the purchase and sale agreement.<sup>21</sup>

Since the condominium association will most likely insure the project, another frequent commercial carve-out pertains to Section 82.111(i) and its requirement that insurance proceeds be used to restore the condominium in the event of damage or destruction unless 80% of the unit owners vote not to restore. In some circumstances, a commercial lender will insist on approving the use of insurance proceeds for restoration as opposed to repayment of any outstanding indebtedness.

### V. CONCLUSION

In many respects, the potential of TUCA as a development tool is just now being realized. We have just begun to use its inherent power and flexibility to address unique residential and commercial development configurations and integrated multi-use developments. TUCA and the condominium form of ownership are, in many respects, more flexible and powerful than traditional platting options and non-condominium based governance systems. At bottom, TUCA and the condominium form of ownership is a means to segregate ownership, allocate costs, and regulate development and use...in three dimensions.

<sup>21</sup> Section 82.158 also allows a real estate broker, attorney, bonded escrow company or financial institution hold the funds.

