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Legal challenges in managing privatized apartment buildings

The way in which apartment block ownership and administration can be effectively managed is a problem which has come to the forefront because of the mass privatization and sale, or granting, of apartments to former tenants in new EU member states. In these cases there are inadequacies in the law ensuring the continuous maintenance and renovation of common parts, such as the roof, walls, stairwells and lifts, and of utilities, such as water, sewage and electrical systems (Gruis *et al*. 2009). Several old EU member states, such as France, are also interested in legislative solutions for home ownership problems in apartment blocks (Association des Responsables de Copropriété (2007). The issue is, however, broader – as the lack of a well-functioning legal ownership is also a problem in**,** for instance**,** Russia and in Balkan and Caucasus countries, as well as in China.

This article reviews what is meant by apartment ownership in condominiums, and how these apartment blocks are governed. This raises issues concerning the decision-making process for such governance, how to finance repairs using ownership as collateral, how to enforce payment of charges for current and future repairs to common parts and facilities and how to ensure that governance is transparent. The Finnish model for apartment ownership provides solutions to many of these problems. Looking at this, allows an analysis of the factors which can be used to assess apartment ownership in different countries. There is a general lack of comparative work of the law in this area, and such an assessment would provide a basis for comparison and help improve legal structures of apartment ownership in many countries.

Problems with Condominium Ownership

In most cases the legislative solution applied could be described as a “condominium model”. This model means that the owners own their dwelling, but, more accurately, they own the space which is defined by the internal walls of the dwelling, which might not be connected to the ground on which the building stands. Their ownership is listed as property in official records. The common parts are, however, owned jointly by all owners.

For most condominiums, the management of commonly owned parts and facilities can be organized by an "owners' association". In the United States this is also, for instance, called "organization of unit owners" (for example, under the General Laws of Massachusetts, Part II), in Canada "condominium corporation" (The Condominium Act, 1998, and in England and Wales "commonhold association" (Commonhold and Leasehold Reform Act 2002**).** It should be noted that in the United States the legal form of "organization of unit owners" can be a corporation, trust or association. Its legal status differs greatly in different countries or states. In this paper the notion "owners' association" is used because it is probably the most common form among different countries.

Alternatively, the administration of the apartment block can be based on a condominium-only solution, which is used here to mean that the owners have to co-manage the management, maintenance and repair of common parts without any specifically designated decision-making body. In this case, the traditional solution is that a management agent makes most decisions concerning the management of the condominium. It is clear, however, that this kind of solution produces a number of administrative problems. One of them is that the unit owners should always have the authority, if they

are dissatisfied with the performance of the management agent, to discharge the agent and choose a new one (see, for instance, the Uniform Condominium Act (1980) in the US and the Real Right Law of the People's Republic of China).

Yet owners' associations are, in many countries, optional and thus have been set up in only a fraction of condominium blocks. This is the case in many former socialist countries, especially when condominiums are created in existing buildings where sitting tenants have become owners (Economic Commission for Europe, 2003: 7 and 17).

The legislation of the Russian Federation seems to be a special case, because even if an owners' association exists, membership is voluntary. A former law of the Russian Federation Law on Homeowners' Associations made this membership compulsory, but that was found to be unconstitutional by the Russian Federation Constitutional Court (IUE 2003, 99) as contrary to the right of free association (Vihavainen 2007: 6 and Institute for Urban Economics 2003: 99).

A much more effective solution is to combine the condominium model with owners' associations (Economic Commission for Europe, 2003: 7). However, the legal framework varies greatly in different countries and this model also often has deficiencies in several areas.

1. The decision-making process

The most important question here is how to organize decision-making in such a way that it guarantees the opportunity for all owners to participate in major decisions concerning the property and its administration. However, if the law requires unanimous support for decisions concerning major repairs, this naturally creates severe difficulties in reaching a decision. There are many different rules about majority voting – simple or qualified (two-thirds, three-quarters, etc.). In addition, a quorum requirement is often used. In this case, a minimum percentage of the members of the owners' association or a minimum number of the members of the owners' association present at the meeting could constitute a quorum. One problem with high quorum requirements and the wide use of qualified majority, or even full consensus, is that the owners' association may not be able to reach necessary decisions (see, for instance, Yovera *et al*.: 381-382).

On the other hand, in addition to guaranteeing that the owners' association is able to reach necessary decisions, it is crucial that decisions on everyday management and on other matters which need quick decisions are secured. Therefore, in most countries the meeting of the owners' association elects an Executive Board which, together with managing agents, is responsible for everyday management (see, for instance, Uniform Condominium Act 1980).

2. Financing of major repairs for common parts

The problem is that finance must be raised for major repairs, and mortgage collateral can, in most cases, only be used if individual owners pledge their dwelling for this purpose. It is understandable that not all owners are willing to pledge their dwellings for loans as collateral for certain types of major repair activity. This hampers greatly the use of mortgage collateral.

In the Canadian legislation applied in Ontario, if an owner defaults in the obligation to contribute to common expenses, the corporation has a lien against the owner's unit (in Canada, the owners' associations are called corporations; see closer Condominium Act, 1998, sections 5 and 85). Additionally, in the United States the common practice is that the association has a lien on a unit which may be foreclosed in like manner as a mortgage on real estate (see, for example, the Uniform Condominium Act, 1980, section 3-116), although there is wide variation in legislation between states. A similar approach is used in Sweden where in case some individual owners have not paid their share of the capital costs or in case they have not fulfilled other obligations (such as paying

management fees), the managing board of the owners' association has a duty to engage in recovery proceedings and has the power, according to the law, to initiate even a foreclosure procedure against individual unit owners without a court decision (Österberg 2007: 66-67). This is a strong legal sanction as it bypasses the priority ranking of the traditional mortgage collateral of condominium units (by using a privileged lien). The same approach has been taken in the United States, (Illinois Compiled Statutes, section 9(g)) and in Canada (Condominium Act, 1998, section 86). See also (Roy 2004: 70-71).

The advantage of these approaches is that they solve the collateral problem of a loan provided to an owners' association. One can question, though, if this kind of enforcement is too harsh for relatively small delays in payment. On the other hand, if the unit owners know that the owners' association is prepared to use this kind of measure in practice, this approach can work, as the unit owners will probably pay their delayed payments rather than end up in the foreclosure procedure**.** It is also evident that before entering such a process, the owners' association has to first use the normal procedure for seeking to collect payment**.**

The owners' association may naturally also get other types of loans. The question is what kind of collateral can be used in this connection? One option is to use the cash flow of the owners' association as collateral. This approach is frequently used in Estonia. On the other hand, in many other countries, this approach is not accepted by the banks, at least for major loans. Moreover, because the owners' associations do not own the property, mortgage collateral cannot be used in this case and, according to the Basel II rules, this raises the interest level required (Basel Committee on Banking Supervision, 2006: 24). The interest level for these loans may also be higher**,** because the owners' associations in many countries do not usually have clear enforcement measures that work against owners who do not fulfill their obligations. This is discussed in more detail in the next section.

Slovakia, as an example, has taken into use several approaches to address the problem. The bank only lends money to those owners' associations which can prove that they have paid regularly during the last 12 months into the maintenance fund account of the owners' association. The average monthly contribution to the maintenance fund account must exceed the amortization and interest of the loan which is sought by 20%. The bank can thus monitor whether the owners' association is able to make the payments on the loan. At the same time, this maintenance fund account then functions as the first cushion to avoid arrears on the loan. In some cases, as a support to this approach, a certain number of unit owners have voluntarily pledged their unit as collateral. Thus, they have taken the risk that they have to pay an additional part of the capital costs to avoid their unit being taken to a foreclosure process in case some other unit owners do not fulfill their obligations. The assets in the maintenance fund account must always be utilized first. Additionally, there are two other options to diminish the collateral problem in Slovakia – a bank guarantee provided by the Slovak State Bank and a pledge of receivables. A combination of all forms is also possible. (This information was given by Herbert Pfeiffer, Member of the Management Board, Bratislava). If maintenance funds are used to compensate for a shortfall of an individual's payments, or if not all unit owners have to pledge their units as collateral, then clearly there is a cross subsidization between different unit owners.

As the owners' associations often have severe difficulties in getting loans due to lacking collateral, the individual owners have been asked to finance the major repairs through cash payments and loans. This has made the financing of these repairs very difficult in many former socialist countries, as especially the poor owners are often unable to get a loan from the banks (Kährik *et al*. 2003: 232).

3. A lack of means to enforce the collection of payments

In many cases, there are no measures to enforce collection of payment against owners who are not fulfilling their duties, or at least they are not widely used in practice. This concerns, for instance,

many former socialist countries. Where they exist, the basic enforcement measure for payment is the foreclosure procedure, where the unit is sold through a compulsory sale (for example under the German Wohnungseigentumsgesetz 2007, para 18-19, without individuals' consent). For instance in Hungary to force owners to pay their fees, a lien can be put on the property without the lengthy court procedure for debts outstanding for more than 6 months (see Tosics (2004:107).

When individual units are used as mortgage collateral, there are well-defined measures that can be taken, but it is often not defined what can be done in situations where individual unit owners have not paid their fees for common expenses and no legal obligation exists to guarantee payment of these fees, such as in China. In that country if the owner refuses to pay, the law does not give the owners' assembly and the owners' committee any enforcement means to implement their decisions (Real Right Law of People's Republic of China, articles 83 and 98). The reason for not providing enforcement measures or not imposing them, even if such measures exists, is that especially the foreclosure procedure is often so cumbersome to use that the owners' associations have not been willing to apply it. For instance, in many countries, taking a case to court may be politically sensitive or overly time consuming. This is still more evident when a large number of the owners are not able to fulfill their obligations due to low income. Many countries have therefore introduced subsidies to support major repairs and to decrease the housing expenditure of low-income households (see, for instance, The Institute of Urban Economics, 2003: 36-53).

Another feature adding to the difficulty in using the foreclosure procedure as an enforcement method is the lack of rental homes, as nearly all homes in many former socialist countries are owner-occupied**.** Thus, if foreclosure is initiated, owner-occupiers have no rental options available.

More generally, it should be recognized that an important reason why foreclosure is not used in practice is a long tradition of security of tenure, especially in many former socialist countries. This means that there is a conflict of interest between, on the one hand, the security of tenure and, on the other, the equal treatment of different unit owners. To treat unit owners equally**,** it would be feasible for the owners' association to collect not only the amount the unit owner owes, but also charges that arise thereafter and all litigation costs, including reasonable attorneys' fees. There are even stronger measures in the US (Ross 1994). Moreover, this aspect would support administratively light measures in the debt collection procedures**.**

It should be emphasized that enforcement procedures and, more broadly, the possibility that owners' associations may get loans for major repairs, is one of the most important aspects of management to avoid continuous deterioration of the major part of the housing stock in many former socialist countries**.**

4. Lack of transparency

In many cases, the condominium model has resulted in administrative arrangements which are difficult for owners to understand. An administrative model may consist of many different bodies whose functions are not often clear. In some cases, not only the everyday administration, but also a good part of even important decisions are delegated to management agents or companies. An example of this is France, where management is delegated in most cases to a manager, the *syndic*, although there is a council of owners to supervise (Statute of 10 July 1965, articles 17-21). However, delegation of the decision-making power often results in the owners lacking a clear understanding of the management of the property and how their fees are used. One critical problem is to ensure that the capital in the reserve funds is secured and used for its original purpose. In many cases, the auditing processes are lacking efficacy, or at least the owners may not have enough means to influence the selection of the auditors.

These examples show that the question is not only whether owners' associations are compulsory and whether the unit owners are forced to be members, but also how to provide the owners' associations with the necessary legal framework to be able to perform their tasks well.

The Finnish housing company model

These problems were solved in Finland with a special ownership model for apartment blocks and row houses. In this model the property is owned by a housing company, which is a limited liability company. The legal form of the Finnish housing company is not a cooperative, but a separate legal structure. One of the basic differences is that in a cooperative a member can always leave the cooperative, even if the cooperative (or the member who is leaving) has not found a new member as a replacement. This phenomenon has resulted even in bankruptcies among cooperatives, at least in some countries, for instance, in Sweden. In a Finnish housing company, the shareholder is obliged to pay all monthly payments and to fulfill other obligations as long as the shareholder has not sold the respective shares to a new shareholder. This difference is important because the Finnish arrangement ensures that the monetary streams to the company are stable, as compared with housing cooperatives.

The shares of a Finnish housing company are divided in such a way that they correspond to a right of possession of a certain unit. Separate legislation was developed for this ownership model (Housing Companies Act No. 809/1991; see the link to an online version in English in the Table of Legislation). Information is available about this model in a publication comparing housing tenures in the Nordic Countries – Denmark, Finland, Iceland, Norway and Sweden (Karlberg *et al.* 2004: 57-64).

The highest authority is exercised by the shareholders' meeting, which is held at least once a year (Article 29). Each shareholder can vote according to the number of shares he or she owns. The number of shares is generally based on the size of the unit. A housing company's articles of association stipulate the number of shares and voting rights**.**

The shareholders' meeting approves, among other things, a budget, which is used to verify the monthly payments by shareholders (Article 29). The shareholders' meeting also makes decisions concerning major property repairs. Most decisions are made on the basis of a simple majority of votes cast (Article 38). Additionally, the shareholders' meeting elects the board of directors, which constitutes the administrative body of the company and which exercises decision-making power related to the operation of the company. The board consists, in general, of at least three members (Article 50).

The board appoints a superintendent (manager), who is responsible for day-to-day operations of the company, among other things, collecting monthly payments and keeping company accounts (Article 52). The superintendent also prepares various repair-bid documents for the company board, even though the general meeting authorizes the board to make decisions concerning the selection of contractors, for instance, for major repairs. Superintendents are usually employed by a property management agency. Such agencies are usually in charge of at least ten housing companies.

The share certificate of each unit can be used as flexible collateral when taking out loans for purchasing the shares relating to a certain unit or making repairs to the unit. It should be emphasized that the "shares in Finnish residential housing companies, operating in accordance with the Finnish Housing Company Act 1991" enjoy the same status as "mortgages on residential property" in risk weighting by credit institutions in the European Union (European Union Directive 2006/48/EC, Annex VI, Part I, points 45-46). Alternatively, the company can take out loans against mortgage collateral for making repairs to common parts and facilities. This makes it possible to take out loans at the most favorable market rates by using either the share certificate of each unit or the whole property as mortgage collateral**.**

The amortization and the interest payment of the loan taken by the company are paid in conjunction with or as a part of the monthly service charges. These monthly payments are sufficient enough to cover the costs of company administration, repairs and also heating. If the owner fails to pay the monthly payments, the company can take possession of the unit in question for a maximum of three years and pay the unpaid amount using revenue earned from rent. In cases such as this, however, the owner does not lose his or her ownership. This decision is made by the shareholders' meeting. The respective shareholder may then ask a court to examine whether the housing company has grounds to take possession of the unit (Articles 81–85)**.**

It should be stressed that the sanction of having to vacate the apartment in question in order for the housing company to collect rental income on apartments is so strong that the owner would rather pay the monthly payment to the company. Therefore, this sanction is very rarely used**.** If the unit is rented out by the shareholder, the company will conclude the lease with the new tenant.

The Finnish housing company form is also transparent when it comes to financial information, including requirements for book-keeping, annual accounts and auditing. This makes it easier for a shareholder and purchaser of shares, as well as for credit institutions accepting shares as collateral, to anticipate the future housing expenditure related to the apartment. Moreover, transparency of costs makes it easier to determine the apartment price and thus enhances consumer protection.

It should be emphasized that the buyers are not only buying the housing unit itself, but also the housing unit within a building. Therefore, the quality of the common parts and, as a whole, the capability of the management to maintain the quality of these parts into the future is an important aspect when determining the price of the unit and in maintaining the value of the unit owners' personal property.

The following are some of the benefits offered by a limited liability housing company:

1. Decision-making responsibilities are clearly defined and the property’s common parts have one specified owner.

2. Loans can be granted, on the one hand, for repairs of common parts and, on the other, for apartment-specific needs (the purchase of the unit or apartment-specific repairs).

3. It is easy for the owner to sell housing company shares corresponding to a certain unit (e.g. easier than selling a car).

4. The debt-collecting system for those who have not paid their monthly payment functions well, which means that these sanctions are rarely used.

5. The result of this clearly defined decision-making process is that the buildings and their common parts are in good condition and adequate repair measures can be taken. This is crucial to ensuring that property value is maintained and that the living standard is kept high.

6. Shareholders can be either individual people or other entities, like corporations or municipalities. Individual people can either live in their own dwelling or rent it out. As a result, the housing company model enables the integration of owner-occupied dwellings and rental dwellings in the same buildings and thus decreases segregation.

7. The housing company system has been functioning in Finland without any major problems already from the 1920s. As a consequence of this, the proportion of housing company dwellings in the housing stock is as high as 40%.

General Conclusions and Framework for Analysis

There is a long tradition of condominium housing in some Southern European countries and in Latin America. However, in common law countries and many others, condominiums along the lines described in this article are relatively recent and used with other forms of apartment ownership (Rudd *et al.* 1996).

This raises two points worth mentioning. Firstly, as the condominium legislation is fairly new in most countries, the buildings erected following this concept are relatively young and the need for major repairs has not occurred on a full scale yet**.** The second is that, for instance, in the United States only 5% of Year-Round Housing Units are condominium units, in a formal legal sense of the word (Eggers and Thackeray, 2007: 4 and 9).

The circumstances are very different in many former socialist countries, where a major part of the whole housing stock was transferred to condominium ownership. Most of these buildings were built in the 1960s and 1970s, which means that major repairs will be needed in the near future. An important aspect in these countries is that many owner-occupiers are poor and thus unable to pay the rising energy costs and the required major renovations. Therefore, even well-functioning legislation will not be enough to prevent these buildings from undergoing continuous deterioration in many countries. On the other hand, if the legislation does not function well in getting loans to finance a good part of the renovations needed this is most likely to worsen the problems.

In most of the old EU member states (i.e. became EU members in 1995 or earlier**),** the share of owner-occupied flats of the housing stock is low. Even here, the legislation for home ownership in apartment blocks lacks efficacy in many countries.

Concurrently, in emerging economies, a growing challenge is the ownership pattern in large-scale developments in many fast-growing metropolitan regions. A special challenge in these countries is that these condominium blocks often have a huge number of units, which requires additional efforts in the transparency of the legal structure and in management of the common parts of the buildings.

Most countries have believed that the condominium concept is the only solution to home ownership in apartment buildings. For this reason, none of them have critically compared the different existing patterns of home ownership before choosing the condominium approach. For new production and actions for further privatization of rental property, countries are naturally free to choose between different approaches**.** However, it is not just a matter of choosing between approaches, because even within each approach (like the condominium model), there has been a constant need for improvements and legislative amendments**.** It should be stressed that there are some very diverse solutions and countries can benefit from comparative research.

Some questions which should be taken into account when evaluating different ownership patterns are:

1. What is the organizational structure (i.e. which bodies are making different decisions and how)?

2. How long does it take to make different types of decisions (i.e. concerning emergency repairs or major repairs)?

3. How is the financing of major repairs of common parts organized and what kind of collateral can be used?

4. How is the financing for the purchase of a unit or the repair of a unit organized and what kind of collateral can be used?

5. Are there functioning enforcement measures against unit owners who are not fulfilling their obligations?

6. Do the owners have access to relevant (e.g. financial) information on the management of the building and on, for instance, the maintenance costs, and can they elect auditors and also otherwise monitor the decision-making processes?

The question of increasing owner-occupation in multi-family housing stock is a huge challenge. Although there is a growing literature on the topic, some examples of which are in the table of references, there has been only limited comparative research on the legal structures implemented in different countries**.** Therefore**,** what the legal community should do is to critically evaluate the existing models and provide a well-founded base for important decisions to be made in different parts of the world. Legal precision is, in this connection, essential**.** The main challenge here is to focus on the management and repair of common parts of apartment buildings. In this regard, a well-functioning legal background is an important issue.

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