

## Fannie And Freddie's New Commercial Space Requirements

Law360, New York (August 12, 2016, 12:04 PM ET) -- Within the past year, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation have each released updated requirements for approving mixed-use condominium projects. The most important change in those requirements relates to the calculation of commercial space in mixed-use condominium projects. Specifically, each agency has clarified that when calculating the percentage of commercial space in a project, you not only count the space in the legal condominium itself, but also in the *building in which the project is located*, even if the commercial space has separate ownership.



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In the past, many condominium attorneys would structure projects to avoid the commercial space restrictions by separating the various condominium regimes into discrete commercial and residential components, either through air rights subdivisions or by utilizing a master/sub association structure. Through that structure, many developments that otherwise would have exceeded the commercial space restrictions were still eligible for secondary market approval. However, under the revised guidelines, this strategy will no longer be successful.

### Maximum Percentage of Commercial/Nonresidential Space

Both Fannie Mae and Freddie Mac have increased the maximum amount of commercial or nonresidential space allowed in an approved project from 20 percent to 25 percent in recent years. [1] The Federal Housing Administration has actually allowed up to 25 percent commercial space since 2011.[2] Notably, the VA does not have a fixed maximum.[3] In addition, several of the secondary market government-sponsored enterprise provide for exceptions to the above limits, as discussed further below.

### Calculation of Commercial/Nonresidential Space; Changes to Deal Structure

The most impactful change in Fannie and Freddie's new requirements for mixed-use condominium projects is the clarification of how commercial space should be calculated within a project. The clearest way to understand this change is to look at the evolution of the language in the revised requirements.

As recently as November 2014, the Fannie Mae Single Family Selling Guide stated that "projects in which the total space that is used for nonresidential or commercial purposes exceeds 25 percent" are ineligible for secondary market approval.[4] In November 2015, this provision was changed to read "Fannie Mae requires that no more than 25 percent of a condo or co-op project or *25 percent of the building in which the project is located* be commercial space or allocated to mixed use. This includes commercial space that is above and below grade." (emphasis added).

Similarly, as of September 2015, the Freddie Mac Single-Family Seller/Servicer Guide stated that "a project in which more than 25 percent of the total square footage of the project is used for nonresidential or commercial purposes" is ineligible. In March 2016, this was changed to "a project

in which more than 25 percent of the total above and below grade square footage of the project (or more than 25 percent of the total above and below grade square footage of the building in which the project is located) is used as commercial or nonresidential space” is ineligible (emphasis added).

As discussed in the introduction, these clarifications are significant. For example, imagine a developer intends to build a new downtown mixed-use condominium building in Washington, D.C., where floor one contains retail, floors two to three contain office space and floors four to six contain residential condominium units. If each floor is deemed to have equal square footage (setting aside, for now, the subtleties of the required calculations), the proposed project would be 50 percent commercial and 50 percent residential. In the past, a developer could still secure secondary market approval on this development by splitting the residential condominium from the rest of the building either via an air rights subdivision or a master condominium structure. Under the old definition, most lenders were willing to treat commercial space as not counting at all against the total commercial space allocation in a project. However, the new requirements leave no room for ambiguity. No matter the legal structure of the development, any commercial space in the entire building must be counted. The Fannie Selling Guide drives this point home when it states that the calculation “includes the total square footage of commercial space even if the residential and commercial owners are represented by separate associations.”[5] A chart covering various legal structures was included in the latest Fannie Guideline and is below.

### **FANNIE MAE SELLING GUIDE CHART**

<b>If the commercial or mixed use space is...</b>	<b>Then its square footage is included in the calculation of commercial space percentage</b>
Owned, controlled, or operated by the subject property’s HOA that is unrelated to the project specific amenities offered for the exclusive use and enjoyment by the HOA members	YES
Owned by the subject property’s HOA but controlled or operated by a separate private entity Example: Office space owned by the HOA but leased to a private business. owned and controlled by a project HOA other than the subject property’s HOA that shares the same master HOA with the subject property’s HOA AND the commercial space is co-located in the project’s building(s) that contain(s) the residential units	YES
Owned, controlled, or operated by a private entity that is co-located in the building(s) that contain(s) the project’s residential units  Example: <ul style="list-style-type: none"> <li>• floors 1 to 4 consist of hotel and retail,</li> <li>• floors 5 to 7 consist of privately owned and managed rental apartments, and</li> <li>• the remaining floors consist of the condo project units.</li> </ul>	YES
Owned, controlled, or operated by a private entity that is NOT co-located in the building(s) or common elements as declared in the project legal documents that contain(s) the project’s residential units	NO
Owned and controlled by a project HOA other than the subject property’s HOA that shares the same master HOA with the subject property’s HOA BUT the commercial space is located in a building that is separate from the building(s) containing the project’s residential units	NO

The Fannie and Freddie Selling Guides also set forth various other clarifications on how commercial space should be counted. For example, rental apartments that are leased to tenants must be considered commercial space, even if such use is arguably "residential" in nature.[6] The Fannie Selling Guide also provides examples of commercial space, including parking that is not allocated to the use of the residential units, hotels, restaurants and fitness facilities open to the public.[7] To be included in residential space, an amenity must be residential in nature, designated for the exclusive use of the residential unit owners and owned by the unit owners or HOA.[8] Freddie Mac has nearly identical provisions in its selling guide.[9]

## **Additional Mixed-Use Restrictions and Obligations**

There are several additional requirements related to mixed-use condominium projects. For example Fannie and the FHA require that any commercial space be "compatible" with the overall residential nature of the development.[10] The FHA also requires that the commercial use be "free of adverse conditions to the occupants of the individual condominium units".[11] The VA on the other hand requires the attorney opinion letter submitted with the approval request to include a detailed explanation of the mixed-use arrangements at the project and opine on the voting rights of residential units as well as the protection of minority interests.[12]

In addition, both Fannie and Freddie have adopted limits on the number of units that may be owned by a single investor. Specifically, Fannie and Freddie consider a project ineligible if a single investor, or affiliated persons or entities, owns more than one unit in a two-to-four unit project, more than two units in a five-to-20 unit project, or more than 10 percent of the units in a project with 21 or more units.[13] Units may only be excluded from an investor's total if they are vacant and actively being marketed for sale.[14] The FHA has its own restrictions on investor concentration that have been in flux based on several temporary rulemakings issued as mortgage letters.[15]

These restrictions are important because many mixed-use developers desire to sell some or all of the residential units, but retain the commercial space and potentially certain residential units to lease as apartments. It is thus important for the developer's attorney to make sure that the condominium is structured in a way that the developer's retained units do not run afoul of these requirements. This can generally be achieved by bundling all of the commercial space in a single unit, but every new development will raise unique issues.

## **Potential Solutions**

The primary issue created by the revised guidelines can be addressed in a few ways. First, a developer may structure the development to avoid surpassing 25 percent commercial space in the building in which the project is located. While this provides the most certainty and allows a developer and its lender to proceed with a more standardized approval process, this solution will obviously not work in all cases. There are two other options available to a developer however.

First, a developer may elect to submit the condominium for approval through Fannie Mae's PERS review process (Project Eligibility Review Service).[16] PERS is a more thorough review process that has the power to approve over 25 percent of commercial space in a project. Unofficially, projects have been approved at up to 40 percent commercial space through the PERS process. Another benefit to PERS is that the project will then be eligible for Freddie Mac approval through Freddie's "Reciprocal Project Review" process, which has the ability to approve PERS approved projects, subject to certain conditions.[17]

Unfortunately, there are some down sides as well. First, there is no guarantee a project will be approved, and ground up construction is less likely to be approved than a fully sold established project. Second, the heightened review adds time to the approval process and carries a fee of \$7,500, plus \$30 for every unit in the project. Third, PERS approval is only valid for 18 months, after which time it needs to be renewed. All that being said, PERS will still be the best option for many developers and lenders.

The FHA provides for a similar exception process.[18] The first step is a more thorough review that can approve up 35 percent commercial space.[19] However, a project is not eligible for this review unless (i) it has been completed for over a year and (ii) control of the board of directors

has been transferred to the units owners. For projects with commercial space between 35 percent and 50 percent, an even more rigorous review is required, as detailed in several mortgage letters setting forth temporary rules with respect thereto.[20] Because the FHA exception reviews only accept established projects, they are of limited usefulness to a ground-up developer.

## Conclusion

While the revised regulations prohibit one of the most commonly used tools of mixed-use developers, lenders and their attorneys over the past 20 years, they at least provide clarity on issues that are better dealt with at the beginning of a project rather than as a surprise at the end. As the PERS review becomes more commonplace, the issues raised by the recent changes may become muted by the availability of that process. Finally, as this is a rapidly changing area of the law, more modifications could be on the horizon.

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[1] Cf. Fannie Mae Single Family Selling Guide (November, 2014), Section B4-2.1-02 (requiring no more than 25% commercial space), <https://www.fanniemae.com/content/guide/sel111014.pdf> (hereafter the "Fannie Guide"); and Fannie Guide (July, 2013), Section B4-2.1-02 (requiring no more than 20% commercial space), <https://www.fanniemae.com/content/guide/sel073013.pdf>; and cf. Freddie Mac Single-Family Seller/Service Guide (June, 2015), Section 5701.3 (requiring no more than 25% commercial space), <http://www.freddiemac.com/singlefamily/guide/bulletins/pdf/063015Guide.pdf> (hereafter the "Freddie Guide"), and Freddie Guide (March, 2015), Section 42.3 (requiring no more than 20% commercial space), <http://www.freddiemac.com/singlefamily/guide/bulletins/pdf/031715Guide.pdf>.

[2] FHA Condominium Project Approval & Processing Guide (June, 2011) Section 2.1.3, <http://portal.hud.gov/hudportal/documents/huddoc?id=11-22mlguide.pdf> (hereafter, the "FHA Guide").

[3] See 38 C.F.R. 676-679 (2005) (38 CFR §36.4360a(g)) ("Commercial areas. With respect to existing and proposed condominiums, commercial areas within condominium developments are acceptable, but such interests will be considered in value."), <https://www.gpo.gov/fdsys/pkg/CFR-2005-title38-vol2/pdf/CFR-2005-title38-vol2-sec36-4360a.pdf>; see also Veterans Admin., Lenders Handbook, VA Pamphlet 26-7, Section 16-8.02 and 16-B, Exhibit A, Section (A)(4)(a) (Veterans Admin. 2000), [http://www.benefits.va.gov/WARMS/docs/admin26/pamphlet/pam26\\_7/ch16.doc](http://www.benefits.va.gov/WARMS/docs/admin26/pamphlet/pam26_7/ch16.doc) (hereafter the "VA Lenders Handbook").

[4] Fannie Guide (November, 2014), Section B4-2.1-02.

[5] Fannie Guide (November 2015), Section B4-2.1-02.

[6] Fannie Guide (November 2015), Section B4-2.1-02.

[7] Fannie Guide (November 2015), Section B4-2.1-02.

[8] Fannie Guide (November 2015), Section B4-2.1-02.

[9] See Freddie Mac Guide (March, 2016), Section 5701.11

[10] Fannie Guide (November 2015), Section B4-2.1-02; and FHA Guide, Section 2.1.3.

[11] FHA Guide, Section 2.1.3.

[12] VA Lenders Handbook, 16-8.02 and 16-B, Exhibit A, Section (A)(4)(a).

[13] Fannie Guide (November 2015), Section B4-2.1-02; and Freddie Guide (March, 2016), Section 5701.3(k).

[14] Fannie Guide (November 2015), Section B4-2.1-02.

[15] See FHA Guide, Section 2.1.3; as amended by Mortgage Letter 2012-18 (Sept. 13, 2012), Mortgagee Letter 2014-17 and Mortgagee Letter 2015-27 (November 13, 2015). Note that the provisions contained in the Mortgage Letters are temporary and are subject to expiration or renewal. Mortgage letters are available at [http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/administration/hudclips/letters/mortgagee](http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/letters/mortgagee).

[16] Fannie Guide (November 2015), Section B4-2.2-06; Fannie Mae Project Eligibility Review Service (PERS) Overview Fact Sheet, [https://www.fanniemae.com/content/fact\\_sheet/pers-overview.pdf](https://www.fanniemae.com/content/fact_sheet/pers-overview.pdf).

[17] Freddie Guide (March, 2016), Section 5701.9.

[18] See FHA Guide, Section 2.1.3; as amended by Mortgage Letter 2012-18 (Sept. 13, 2012), Mortgagee Letter 2014-17 and Mortgagee Letter 2015-27 (November 13, 2015).

[19] See id.

[20] See id.