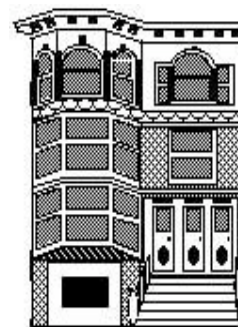


CONDOMINIUM CONVERSION IN SAN FRANCISCO

(02/03/09)

BY D. ANDREW SIRKIN
SIRKIN PAUL ASSOCIATES
250 MONTGOMERY STREET, SUITE 1200
SAN FRANCISCO, CA 94104
(415) 738-8545
WWW.ANDYSIRKIN.COM



What is a condominium?

A condominium consists of an individually-owned "Unit" and a share of group-owned "Common Area". The "Unit" is the space within the walls, floors and ceilings of a dwelling, and the "Common Area" is the remainder of the property. Owners pay their own mortgages, property taxes, and utilities, plus monthly "Homeowners' Association Dues" to cover repair and insurance of the Common Area. A lengthy document called the "Covenants, Conditions and Restrictions" or "CC&Rs" establishes the rights and duties of the condominium owners.

What properties qualify for conversion?

Only 2-6 unit properties may convert. They qualify only when they (i) meet occupancy requirements, (ii) win or bypass the conversion lottery, and (iii) for lottery conversions, satisfy "tenant rights" rules.

Can eviction history disqualify buildings from being converted to condominiums?

A law passed in May 2005 prevents certain buildings from qualifying for conversion based on past tenant evictions. The main points of the law are: (1) A building from which one elderly (60) tenant in occupancy 10 years or more, or one disabled tenant, has been evicted since 5/1/05 for any reason unrelated to the tenant's behavior, can never be converted to condominiums; and (2) A building from which two or more tenants (regardless of age or disability) have been evicted from separate units for any reason unrelated to the tenants' behavior since 5/1/05 can be converted to condominiums only after 10 years of owner-occupancy. These restrictions will not apply to a building if each unit was occupied by a separate owner on 4/4/06. The conversion restrictions apply without regard to whether the current owner initiated or otherwise participated in the evictions. "Eviction" is defined to mean the issuance of a notice terminating tenancy even if the tenant later leaves without further legal action (or in exchange for a "tenant buyout"), but if a property owner issues then withdraws the eviction notice prior to its expiration and the tenant receiving the notice remains in tenancy for at least 120 days following the expiration of the notice, the action would not be deemed to be an "eviction".

How do you bypass the condominium lottery?

Two unit buildings with a clean eviction history bypass the conversion lottery if both units are occupied for one year by separate (unmarried) individuals who each own at least a 25% interest in the property during the entire occupancy period. This exemption from the lottery is also applicable to mixed use buildings having no more than two residential units, both of which are owner occupied. Occupancy is proven by sworn statement. No other building types can bypass the lottery. Vacant apartments do not count as owner-occupied. A two-unit building cannot bypass the lottery if an elderly (over 60 who has resided in the building for 10 years), disabled or catastrophically ill person was evicted from the building after November 16, 2004.

How does the condo conversion lottery work?

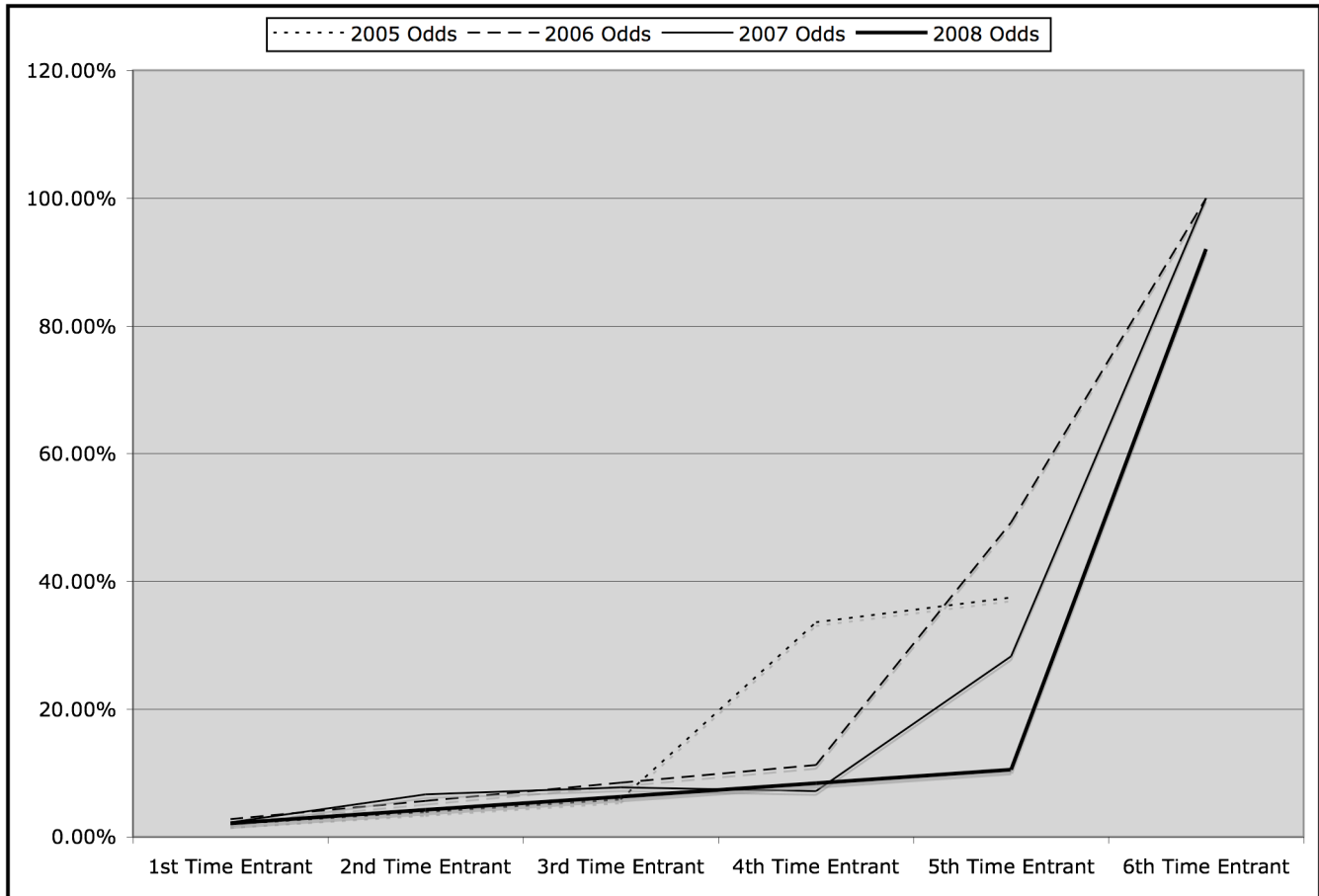
The condominium lottery is held annually during the first quarter of the calendar year. Tickets cost \$250 and are available for a two-month period ending about two weeks before the drawing. (In 2009, the lottery date is February 4 and the entry deadline is January 23). Up to 200 units may be converted through the lottery each year. Note that the lottery selects 200 units, not 200 buildings. The actual number of buildings which convert to condominiums annually through the lottery system is only about 55.

The lottery system is designed to favor buildings that have previously lost. The idea is that your chances of winning will increase each time you enter, but this goal had been undermined in recent years by the rapid increase in the number of buildings entering the lottery. The reality of the last several condominium conversion lotteries (up to 2007) was that even though you accumulated a higher lottery priority in each of the first five years you entered, your chances of winning diminished (except in the fourth year) because there were so many more participants in the drawing. Fortunately, a new system was adopted for the 2006 condo lottery which attempts to guarantee that those who continued to enter the conversion lottery would eventually win. This new system was renewed for 2007, 2008, and 2009, but may not be in place for subsequent years.

Under the new system, the first 100 winning units are selected from among applicant buildings which have lost the lottery at least three times ("Pool A"). Buildings are not eligible to participate in Pool A unless the owners can swear that no elderly (over 60 who has resided in the building for 10 years), disabled or catastrophically ill person was evicted from the building since January 1, 1999. Eligible buildings are grouped according to the number of years they have entered. Buildings that have previously entered and lost six times are considered "Class 6", buildings that have entered and lost five times are considered "Class 5", and so forth. If the number of apartments in the most senior Class is less than 100, all of the buildings in that Class will automatically qualify for conversion. The unused Pool A places are then available for the next most senior Class. For example, if the total number of apartments in the senior Class is 32, 68 places will be available for the next Class. When the number of apartments in a particular Class exceeds the number of places remaining in Pool A, a lottery drawing will select the winning buildings from that Class.

Buildings that do not qualify for, or are unsuccessful in, Pool A are eligible to participate in "Pool B" from which the remaining 100 units will be selected for conversion. Each Pool B entrant gets a number of tickets equal to the number of times it has participated in the condominium lottery. For example, a first-time lottery entrant gets one Pool B ticket while a fifth-time entrant gets five. Buildings from which an elderly, disabled or catastrophically ill tenant was evicted after November 16, 2004 are eligible for only 25 of the spaces in Pool B.

In practice, the new system has produced fairer results than the prior one, but overall the chances of winning are poor and diminishing from year to year. In both 2006 and 2007, all of the sixth-time entrants were automatically selected (there were no buildings in for the seventh or more time in either year), but in 2008 sixth-time entrants had a statistical likelihood of 92.05%. The fifth-time entrants had a statistical likelihood of 10.5%, a significant drop from the same group's 2007 odds of 28.3%. Fourth-time entrants had a statistical likelihood of 8.4% (compared with 7.1% in 2007). Third-time entrants had a statistical likelihood of 6.3% (compared with 7.8% in 2007). Second-time entrants had a statistical likelihood of 4.2% (compared with 6.6% in 2007). First-time entrants had a statistical likelihood of 2.1% (compared with 2.3% in 2007).



Winning buildings must submit a conversion application by a summer deadline. Under the present system an additional 20 buildings are picked at the time of the lottery to go on a standby list in case winners fail to submit applications or are rejected for failure to qualify.

What are the condo lottery owner-occupancy requirements?

For 2-4 unit lottery winners, one unit must be owner-occupied for three years; for 5-6 unit lottery winners, three units must be owner-occupied for three years. The term "owner-occupied" is actually a misnomer as applied in the lottery system; the occupant can be a tenant for three years so long as he/she is an owner at the time of application. Occupancy is proven by sworn statement. The three year period is measured backwards from the lottery entry deadline. So to qualify in 2009, the required number of owners must have occupied continuously since January 2006.

Must the owner-occupants remain the same?

This question is confusing because the occupancy requirements for conversion are different than the occupancy requirements for lottery priority. Conversion requires that the same owner-occupant(s) (one for 2-4 unit buildings, three for 5-6 unit buildings) reside in the property continuously from three years before the lottery entry deadline until the conversion application is submitted. The identity of the qualifying owner-occupants cannot change during those years. Lottery priority requires that one of the qualifying owner-occupants has been an owner (but not necessarily an occupant) during each of the previous lottery losses.

What are the "tenant intent to purchase" requirements?

Lottery winners must submit "tenant intent to purchase" forms signed by residents of at least 40% of the units. The signers may be renters or owner-occupants. These forms state that the signer intends to buy his/her unit as a condominium, but may later decide not to buy. Under this system, only 3-4 unit buildings with a solitary owner-occupant need renter cooperation to satisfy the requirement.

What are the "tenant rights" rules?

All renters (including those who do not sign a "tenant intent to purchase" form) get an opportunity to purchase after conversion at a price established by the owner, all non-purchasing renters get one-year rent-controlled leases, and all disabled and senior (over 62) renters get lifetime rent-controlled leases. At the conclusion of a lease period, renters may be evicted in connection with the sale of a unit. All tenants must be notified of their rights before a lottery conversion application is filed.

What building code requirements apply to conversion?

Converting buildings need not meet current building codes, be seismically upgraded, or have parking. But the City does require a building inspection. The inspection process has six steps: (i) submittal of the inspection request form and fee, (ii) a site visit by City building, plumbing and electrical inspectors, (iii) issuance of a written inspection report, (iv) receipt of a building permit for corrective work, (v) completion of all required work, and (vi) City inspection of the work and issuance of a completion certificate known as a "CFCO". Recently, there has been a delay in obtaining inspections. For two-unit buildings bypassing the lottery, applying for an inspection several months before the one-year occupancy requirement is reached can expedite the conversion. Note that once a City inspection is requested the cited work must be completed whether or not the conversion is pursued.

Inspection reports typically cover three types of problems: (i) work which was completed without required permits (including everything from kitchen renovations to decks to in-law units), (ii) conditions which present safety hazards (like poor fire egress or dangerous electrical wiring), and (iii) energy and water conservation violations. In cases where a significant amount of work is suspected pre-inspection by a private consultant familiar with conversion requirements may be beneficial. Such a consultant can provide advance warning of likely inspection issues, recommend prophylactic measures to minimize work requirements, establish the legality of preexisting improvements, and obtain building permits.

How do qualifying properties begin conversion?

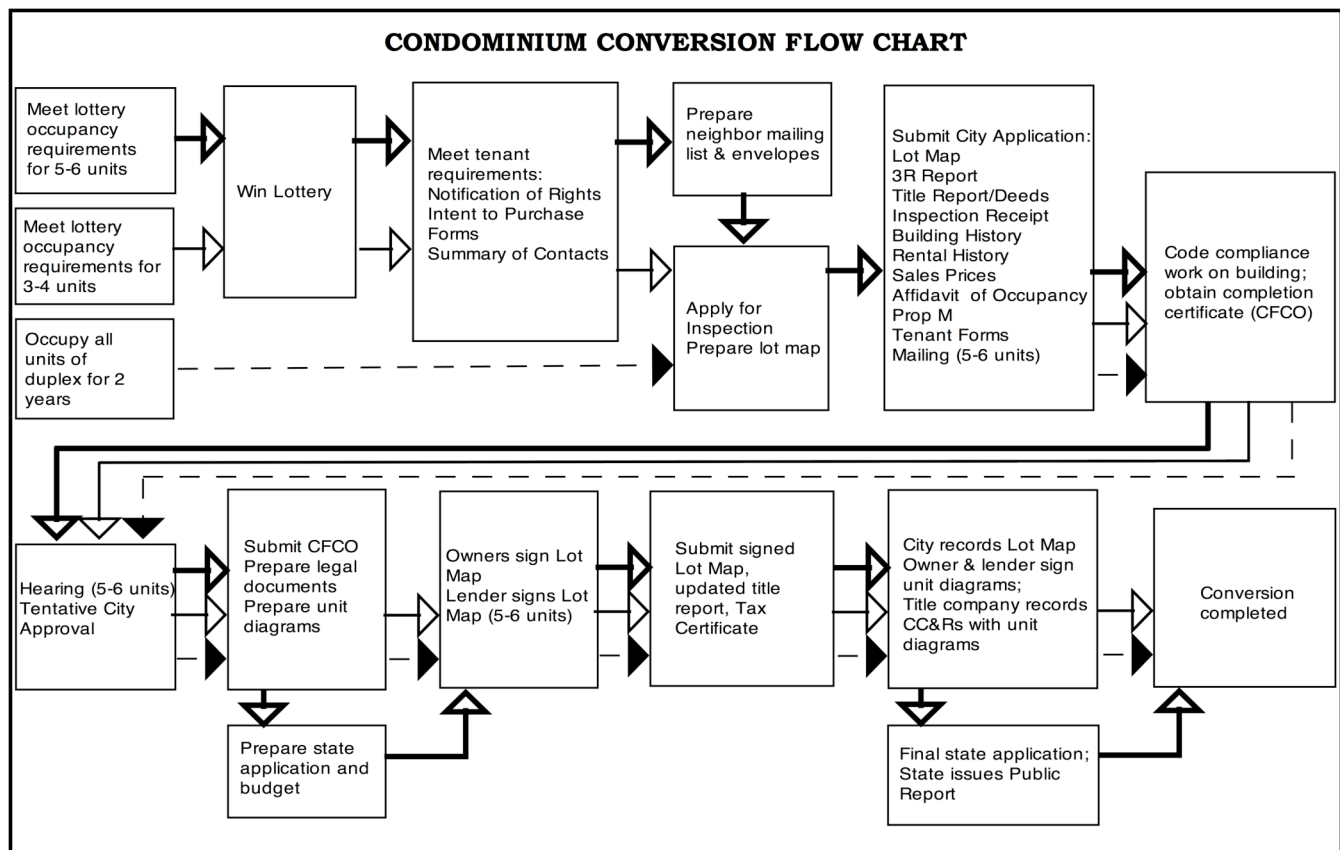
Owners of qualifying buildings (either lottery winners or lottery bypassers) must submit an application package to the City. The major components of the package are:

- **Inspection:** Before submitting a conversion application, you must request a City inspection by mailing in a form and the required fee. The receipt for the inspection fee is part of the conversion application, but you need not have had your inspection in order to submit the conversion application.
- **Survey:** Conversion requires a survey or "condominium map" prepared by a licensed land surveyor which locates the boundaries of the property and footprint of the building. The map and plan take 3-6 weeks to complete. (Note that the surveyor will also prepare unit diagrams, which show the location of the condominium units and other private areas, but the unit diagrams are not part of the City application package.)
- **Occupancy:** Owners or renters needing to prove occupancy must sign a sworn statement.

Owners must also provide evidence they have taken a homeowner's property tax exemption. The package must also include a variety of other items which an attorney can help you compile.

How long does application processing take?

The application is processed by both the Department of Public Works and the Planning Department. During 2007, processing of 2-4 unit properties has taken 10-14 months; processing of 5-6 unit properties, which requires additional City approvals and a State approval, has taken about four additional months. But recent fee and staffing increases at the Department of Public Works are diminishing the processing periods significantly, and current applicants should expect to complete the process in about 12 months. A professional with knowledge of the process and the processors, and the ability to focus on the progress of the application, can accelerate approval.



What other documentation is required?

All condominiums must have CC&Rs which describe the rights and duties of the owners. CC&Rs should be prepared by an attorney and include:

- Homeowners' Association decision making
- Operating budget and maintenance reserve
- Division of financial responsibilities
- Management and record keeping systems
- Maintenance, alteration and usage rules
- Unit diagrams showing the units and other assigned areas such as parking and storage

Properties of 5-6 units must also obtain a "Final Subdivision Public Report" from the California Department of Real Estate by submitting a separate application.

What steps remain after an application is approved?

The approved survey must have a notarized signature from all recorded owners and, in the case of 5-6 unit buildings, all lenders. It is then returned to the City with an updated title report, a certificate of completion of the inspection work, and a Tax Certificate showing property taxes are paid current. The building officially becomes condominiums when the survey and CC&Rs are recorded.

Final recordation does not alter the ownership or financing of the property. All of the condominiums in the building remain owned by the same individual or group, and all remain subject to the same mortgage. Thus if two owners each own 50% of a duplex before conversion, they will each own 50% of both condominiums after conversion. Separation of the condominiums so that particular owners have title to particular units generally requires refinancing with separate mortgages for each unit.

What are the costs of conversion?

The following are the costs incurred in a typical San Francisco condominium conversion:

- **City Fees:** The City charges an inspection fee ranging from \$2300 for two units to \$2700 for six units, an application fee of \$8,790 (2-4 unit) or \$8,897 (5-6 unit), a \$250 lottery fee, a 3R report fee of \$160, and a recording fee of about \$20.
- **State Fees:** The State application is required only for 5-6 units, and the fee is currently about \$1,700. The State also requires a formal budget which is best prepared by a professional budget preparer at a cost of about \$4,000.
- **Surveyor:** Surveys start at about \$7,000 and increase with building size.
- **Attorney:** Typical attorney services include preparation of the City Application, monitoring/troubleshooting, advice on space assignment, CC&Rs, and assistance in lender signing and recordation.
- **Repairs:** Building permit fees and repair costs depend on the extent of needed work.
- **Title:** Most title companies will provide required title reports free of charge if the owner promises to use the same company for a post-conversion sale or refinance of the property.
- **Lender:** Lender charges to sign the survey range upwards from \$750.

Must the pre-conversion lender consent to the condominium conversion?

Until June 2006, the San Francisco Department of Public Works ("SFDPW") would not record the condominium map (the event that signified completion of the condominium conversion process) unless all lenders with mortgages on the property had signed the map signifying their assent to the conversion. If a conversion applicant could not get his/her lender to sign, he/she could not complete the conversion without refinancing with another lender that would agree to sign. Often, this requirement caused delay while the refinancing occurred, and imposed significant additional costs in the form of appraisal fees, loan origination costs, and title and escrow expenses. The new loan would typically be paid off immediately after the condominium map was recorded as the owners sold or financed the condominiums. This inconvenient and expensive process was becoming more and more common as an increasing number of lenders refused to sign.

SFDPW announced in June 2006 that it will no longer require the consent of a property's existing mortgage lenders in order to allow a 2-4 unit property to be converted to condominiums. Although the new policy will allow most owners with non-compliant lenders to complete their conversion, these owners will not be able to record their covenants, conditions and restrictions ("CC&Rs") until they are ready to sell or refinance the condominiums. California law requires that lenders sign the "condominium plan" (an attachment to the CC&Rs which shows the spaces included within each condominium) as a condition of condominium formation. As a result, where the pre-existing lender

has not signed the condominium plan, title companies will require that funds from replacement loans (either refinance loans or purchase loans) be in an escrow account with the title company before the CC&Rs and condominium plan can be recorded. This requirement will impose only a minor inconvenience on condo converting owners because there is no reason to record the CC&Rs and condominium plan until the owners are ready to sell or refinance.

Note that the new SFDPW policy does not apply to buildings containing more than four units. Such buildings will continue to need to obtain lender signature on their condominium maps.

Do I need to refinance after conversion?

Refinancing is not required by most lenders but is necessary prior to transferring any of the condominiums individually. Most owners refinance for the following reasons: (i) to allow the condominiums to be transferred to individual owners or sold separately, (ii) to eliminate the default risk associated with sharing a loan obligation with other owners, (iii) to eliminate the risk that a future job loss, illness, or credit blemish will make refinancing difficult or impossible, (iv) to qualify a unit for eventual exemption from San Francisco's limitation on rent increases, or (v) to replace one large loan on the entire building with several smaller and lower-interest loans on individual condominiums.

Will conversion increase my property tax?

Conversion will not increase the assessed value of your property. The current value will be allocated among the condominiums, and each condominium will get a separate tax bill based on the allocation.

Will conversion increase my insurance premiums?

Conversion often increases insurance costs, particularly in 3-6 unit buildings, and you may be required to switch insurance carriers. Consulting your insurance agent early in the conversion process will help eliminate unpleasant surprises once the conversion is complete.

About the Author

D. Andrew Sirkin is a recognized expert in fractional ownership and other co-ownership arrangements including shared vacation homes, TICs, equity sharing, co-housing, and legal subdivisions such as condominiums. His practice areas include transaction planning, offering materials, co-ownership agreements and CC&Rs, entity formations, regulatory approvals, fractional lending and mediation. Although based in San Francisco, he regularly works on projects located throughout California, and has also worked on projects in nine other U.S. states, Italy, France, Argentina, Nicaragua, Belize and Mexico. He is an accredited instructor with the California Department of Real Estate, and frequently conducts co-ownership workshops for attorneys, real estate agents, corporations, and prospective home buyers. Andy is the co-author of *The Condominium Bluebook*, published annually by Piedmont Press, and *The Equity Sharing Manual*, first published by John Wiley and Sons in November 1994. He has written numerous articles on related topics, including "Vacation Home Co-Ownership", "Questions and Answers on Tenancy In Common", "Owner-Occupancy and Ellis Evictions", "Condominium Conversion in San Francisco", and "Unmarried Couples and Property Ownership", all of which are available at www.andysirkin.com. Mr. Sirkin has been working with co-owner groups since 1986, and has prepared co-ownership agreements for over 6000 clients. Mr. Sirkin can be contacted via email at DASirkin@earthlink.net. Mr. Sirkin can be reached by telephone at 415-738-8545.