

Fractional Interest Real Estate Projects

An Introduction To The Legal Structure

By Sara E. Pope¹

Introduction

Fractional interests are an increasingly popular way of developing and selling recreational and resort properties in British Columbia. It is common to see projects offered as “quarter shares” or in fractions of sixths, twelfths or even fifty-firsts. Buyers are motivated to pay a price for recreational property that reflects the amount of usage the buyer will actually make of the property or to pay a price that buys them more “sizzle” or luxury than they could afford if they bought the whole interest in the property.

The purpose of this paper is to introduce the basic legal structure that creates the interests in a fractional interest project that buyers buy and lenders use as security. Other than the fact buyers can purchase an interest that is less than 100% of the fee-simple interest in a strata lot, a fractional interest project is essentially the same as any other condominium project. All provisions of the *Strata Property Act* apply: buyers are members of the strata corporation, a strata council is elected, a property manager is appointed, there is an annual budget for the strata corporation, there is common property, limited common property, etc. The legal structure and documents that create the fractional interests are in addition to the standard condominium provisions.

What Does a Buyer Get?

A buyer of a fractional interest gets three things:

1. A fee-simple title interest. The buyer is the registered owner on title to the strata lot as to the fraction of the buyer’s interest (i.e. 25%).
2. A sublease (which sets out the period of time the buyer can use the strata lot).
3. One share in the Owners’ Corporation, or a membership in the Owners’ Society (Association).²

Each of the above represents one of the components of the legal structure creating fractional ownership interests.

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² In British Columbia, fractional projects use either a company or society to organize the owners. This article refers to an Owners’ Corporation as this vehicle. For all practical purposes, these references are interchangeable with an Owners’ Society, commonly referred to as an Owners’ Association.

Title

Each buyer of a fractional interest becomes a registered owner in fee-simple of an interest in the strata lot. If the project is sold on a quarter share basis, each buyer receives an undivided one-quarter interest as a tenant in common in the title to the strata lot. The buyer's name will appear on title as the registered owner of the buyer's fee-simple interest.

Headlease and Sublease

In a quarter share project there may be as many as 4 different owners of a quarter interest in a strata lot, each having an undivided one-quarter interest, as tenants in common. Because there is more than one owner and the owners are usually at arms-length to each other, a mechanism is needed to provide for the orderly use of the strata lot by all of the owners.

The lease aspect of the fractional interest program provides this organizational mechanism. After the strata plan is registered and before the first sale to a buyer, a headlease in favour of the "Owners' Corporation" is registered against title to each strata lot participating in the fractional interest program. The headlease grants the Owners' Corporation the right to the use and possession of the strata lot for a period of time, such as 199 years. The Owners' Corporation then grants a sublease of this headlease to each buyer of a fractional interest in the strata lot. The sublease establishes the buyer's right to the use and possession of the strata lot. Both the headlease and the sublease are registered in the Land Title Office and show as a charge on the title to the strata lot.

A summary of some of the important aspects of the sublease is as follows:

1. The sublease is granted by the Owners' Corporation to the buyer at the same time the buyer becomes the registered owner of a fee-simple interest in the strata lot. The conveyance is made in accordance with standard conveyancing practice and the buyer's ownership of both the fee-simple interest and the sublease are registered in the Land Title Office.
2. The sublease is for the same term as the headlease (for example, 199 years) and gives the buyer the right to occupy the strata lot. For instance, in a quarter share project a buyer would have the right to occupy the strata lot for a minimum of twelve weeks in each calendar year (or one week per month). A calendar is attached to the sublease that sets out the weeks of occupation for each quarter interest owner for an initial period, such as 5 years. The Developer will usually designate Thursday, Friday, or Saturday as the change over day for the expiry and beginning of each owner's period of use.
3. The rent for the sublease is nominal (such as \$10 for a 199 year term) and is prepaid. However, the sublease requires the owners to pay the costs incurred by the Owners' Corporation in operating the fractional interest program and maintaining the strata lot. Owners also pay to the Owners' Corporation the owner's proportionate share of the costs of owning real property, such as, strata maintenance fees, real property taxes, utilities, special assessments due to the strata corporation, etc. Requiring owners to pay these costs directly to the Owners' Corporation, who in turn pays the proper authority, assures all owners the bills are being paid and each owner is paying their proportionate share.

4. If an owner is in default under the sublease because, for instance, the owner has not paid their share of the expenses, the sublease provides that the owner forfeits their right to occupy the strata lot during their period of use and the Owners' Corporation can rent out the strata lot during such period to recover the unpaid contribution to expenses.
5. Owners may sell their interest at any time provided the owner is not in default of the sublease and the owner at the same time assigns his rights under the sublease, transfers the fee-simple interest in the strata lot and transfers his shares in the Owners' Corporation to the new owner.

Owners' Corporation and Strata Corporation

The Owners' Corporation functions similarly to a "strata corporation" and is used to manage and administer the fractional interest program. All buyers of a fractional interest automatically become a member of the Owners' Corporation. A buyer gets one share in the Owners' Corporation per fractional interest purchased.

The Owners' Corporation is a company incorporated under the British Columbia *Business Corporations Act*. The articles of the Owners' Corporation are different from standard company articles and are made to address those issues particular to the fractional interest project. Owners are entitled to vote on matters concerning the Owners' Corporation, including the election of a Board of Directors and the annual Owners' Corporation Budget at each annual general meeting of the Owners' Corporation.

All fractional interest owners are also members of the strata corporation. The *Strata Property Act* provides that each strata lot has only one vote at meetings of the strata corporation. Typically the articles of the Owners' Corporation or the terms of the sublease provide for how the vote at the strata corporation meetings will be exercised.

The following is a summary of some of the differences between and similarities of the Owners' Corporation and a strata corporation:

1. Under the British Columbia *Strata Property Act*, a "strata corporation" is created when a strata plan is filed in the Land Title Office. As provided by the *Strata Property Act* all the owners of the strata lots in that strata plan are automatically members of the strata corporation. A strata corporation is governed by the *Strata Property Act*.
2. The Owners' Corporation is a company created under the British Columbia *Business Corporations Act*³. Its incorporation documents are on file with the Registrar of Companies in Victoria and is governed by the requirements of the *Business Corporations Act* and its articles of incorporation. The Owners' Corporation must file annually certain documents with the Registrar of Companies in order to remain in good standing. An owner must be a shareholder to be a member of the Owners' Corporation.
3. Simply stated, the strata corporation is responsible for all matters that are external to the strata lot, such as the common property and building exteriors. The budget of a strata corporation typically provides for landscaping and maintenance, fire insurance, garbage removal, common area hydro, window cleaning, chimney cleaning, etc.

³ If an Owners' Association is used, a society is created under the British Columbia *Society Act*.

4. The Owners' Corporation is responsible for all matters that are internal to the strata lot and for the operation of the fractional interest program. The Owners' Corporation budget provides for reserves for the furnishings, maintenance and repairs to the interior of the strata lot, utilities, property taxes, strata fees, contents insurance, etc.
5. A strata corporation has a strata council and the Owners' Corporation has a board of directors. The council is elected from the members of the strata corporation and the board of directors is elected from the members of the Owners' Corporation.
6. Both usually retain the services of a professional manager to assist them with their obligations and functions.
7. Both have a budget for those costs relevant to their functions. The budgets are set at the annual general meetings of the members of the strata corporation or the Owners' Corporation, as the case may be.

Owners' Corporation Manager

The developer of a fractional interest project arranges for the Owners' Corporation to retain a manager to manage and administer the affairs of the Owners' Corporation and by extension, the strata lots in the fractional interest program. Typically, the Owners' Corporation enters into the management agreement with the manager while the developer still controls the shares in the Owners' Corporation. The manager is paid for its services in accordance with the terms set out in the management agreement. The services of the manager would include the following:

1. **Owners' Corporation Services:** These services involve managing the corporate structure of the Owners' Corporation, arranging for the legal and auditing functions of the Owners' Corporation, managing key pick-up and drop off services for owners, collecting assessments from owners, paying all authorized disbursements (i.e. the real property taxes, strata maintenance fees, utilities, etc.).
2. **Full Management Services:** These services involve conducting change-over cleanings, arranging for an annual clean of each strata lot, replacing furniture, fixtures and equipment, repairing any damage caused by an owner beyond normal wear and tear, collecting the appropriate reserves, and generally carrying out the overall supervision and management of the interior of the strata lots.

Owners' Corporation Budget

At the annual general meeting of the Owners' Corporation the owners vote on and approve an Owners' Corporation Budget for the next fiscal year. Owners are required by the sublease to pay monthly their share of the Owners' Corporation Budget. These payments are in addition to the monthly contributions owners make to the strata corporation. A typical Owners' Corporation Budget would provide for the following expenses:

1. **Fixed Ownership Expenses:** These expenses are those incurred as a result of being the registered owner of property. Examples of these expenses are as follows:
 - Cable, Telephone & Utilities
 - Content & Liability Insurance

- Property Taxes
 - Strata Fees
2. **Owners' Corporation Expenses:** These expenses relate to providing the "Owner's Corporation Services" (as described above). In particular these are expenses that relate to maintaining the fractional interest program and the associated structure of the Owners' Corporation.
3. **Full Management Expenses:** These expenses relate to providing "Full Management Services" (as described above). In particular these are expenses that relate to the management and maintenance of the interior of each strata lot. Examples of these expenses are as follows:
- Annual Clean: Typically strata lots are subject to a thorough clean and repair program that occurs once a year over a several day period.
 - FF&E Reserve: The FF&E ("Furniture, Fixtures and Equipment") Reserve is a replacement reserve to be used for the long-term repair and maintenance of the in-unit furnishings.
 - Change-Over Cleaning Expense: This expense relates to the cost of the "change-over clean" done each time a strata lot is vacated following usage of the strata lot by an owner.

Summary

The various components creating the structure of a fractional interest project are designed to give each owner certainty in respect of the time an owner may use their strata lot and to manage the payment by each of owner of their proportionate share of the expenses necessary to maintain and operate the fractional interest program. The headlease/sublease and the Owners' Corporation are the tools used to safeguard each owner's interest within a structure that arranges for the ownership of less than a 100% fee-simple interest in a strata lot.

This article provides a summary and overview of fractional interest projects in British Columbia only. The article is not legal advice. Any one requiring specific information or advice should contact a British Columbia lawyer.



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