

Attachment B

To: Benjamin Berbert, Lisa Govoni

From: Alex Pemberton

Date: July 28, 2025

Subject: Economic Non-Viability of Small Condominium Projects Under Proposed SRA 25-02

Ben and Lisa,

This memorandum outlines the key economic and legal challenges that make small-scale condominium projects financially unworkable in Montgomery County.

Your concern is valid—by prohibiting the creation of fee-simple flag lots for Optional Method Workforce Housing (OMWH) projects, SRA 25-02 effectively forces small, townhouse-style developments into a condominium or rental model. While rental viability is typically a matter of simple development math, the shift to condominium legal structures triggers a cascade of financial and legal burdens under Maryland law that render such Missing Middle housing projects economically non-viable.

Small condominium projects face disproportionately high fixed costs, significant developer liability, and, most critically, severe barriers to accretive financing for end-buyers.

1. The Financing Gauntlet: The "Non-Warrantable" Condo Trap

The single greatest obstacle is the inability of small condo projects to achieve "warrantable" status, which is essential for buyers to secure conventional mortgage financing. A project is "warrantable" if it meets the strict guidelines of Fannie Maeⁱ and Freddie Macⁱⁱ. Units in "non-warrantable" projects are ineligible for the most common and affordable mortgages; buyers must instead seek portfolio loans, which typically require higher down payments (10-25%)ⁱⁱⁱ and interest rates 0.5% to 2.5% higher than conventional loans.^{iv}

Small projects are likely to be classified as non-warrantable due to the following rules:

- **Single-Entity Ownership Concentration:** For projects with 5-20 units, a single entity (including the developer) cannot own more than two units. For a three-unit project, this means the developer cannot retain two units as rentals during the sell-out phase without making the entire project non-warrantable for a potential homebuyer.
- **Mandatory Reserve Funding:** Fannie Mae and Freddie Mac require that 10% of the association's budget be allocated to a reserve fund. Combined with Maryland's mandatory funding laws^v, this can result in high, inflexible HOA fees^{vi} (e.g., \$300-\$500/month) for small projects, which are comparable to fees in much larger buildings with more amenities.
- **Developer Control & Pre-Sale Requirements:** A project is generally not warrantable until the developer has turned over control of the HOA. Furthermore, Fannie Mae requires that at least 50% of the units be sold or under contract to owner-occupants, a difficult threshold to meet when financing for the initial buyers is uncertain.

2. Disproportionate Burden of Fixed Costs

Creating a condominium regime imposes substantial fixed costs that do not scale down for small projects, making the per-unit cost prohibitive. For a typical 5- to 20-unit project, these additional costs can exceed **\$100,000** in upfront, at-risk developer equity.

- **Legal and Surveying Fees:** Preparing and filing the required condominium documents (declaration, bylaws, and plat) costs between **\$35,000 and \$50,000**, regardless of project size. This contrasts with **\$5,000 to \$8,000** for a fee-simple subdivision. The complex three-dimensional plat adds another **\$15,000 to \$25,000** in surveying costs.^{vii}
- **Professional Insurance Premiums:** Insurers view any condominium work as high-risk due to the threat of construction defect litigation, leading to significant surcharges.
 - **Architect & Engineers (A&E) Errors & Omissions (E&O) Insurance:** Only ~40% of insurers providing A&E E&O coverage in the U.S. underwrite condominium projects at all; A&E firms with E&O coverage for condominium projects are typically large firms oriented toward large-scale projects. The insurance carriers who offer coverage often impose a 25-50% premium surcharge for any condo project, adding **\$8,000 to \$12,000** in design costs for a small multi-unit project.^{viii}
 - **Developer Liability Insurance:** Maryland's extended developer liability period requires 7- to 10-year tail coverage, adding **\$15,000 to \$25,000** to project costs.

3. Maryland-Specific Statutory Hurdles

Maryland's condominium law, while providing strong consumer protections, adds layers of cost and risk that are particularly challenging for small developers.

- **Mandatory Reserve Studies:** Unlike neighboring states like Virginia where reserve studies are optional, Maryland mandates a professional reserve study every five years with required funding to recommended levels. This creates high, unavoidable carrying costs that reduce affordability.^{ix}
- **Extended Developer Liability:** Maryland provides a three-year implied warranty on common elements and prohibits developers from contractually shortening the statute of limitations for construction defect claims.^x This extended exposure period increases developer risk and insurance costs compared to states like Virginia or Pennsylvania, which allow for negotiated warranty periods. The need to carry expensive completed operations insurance and maintain capital reserves for potential claims adds an estimated **3-5% to total development costs**.

Conclusion and Recommendation

The intent of SRA 25-02 may be to prevent awkward site layouts, but its practical effect is to mandate a condominium structure for small, townhouse-style infill projects. As demonstrated, this path is economically toxic. The combination of financing barriers from "non-warrantable" status, disproportionately high fixed costs for legal and insurance compliance, and Maryland's strict

liability framework makes small condo projects un-buildable for most developers and unaffordable for the workforce buyers the legislation aims to help.

By prohibiting a fee-simple subdivision option via flag lots, SRA 25-02 will inadvertently stifle, rather than encourage, the creation of much-needed "missing middle" housing.

ⁱ <https://selling-guide.fanniemae.com/sel/b4-2.1-01/general-information-project-standards>

ⁱⁱ <https://guide.freddiemac.com/app/guide/section/5701.2>

ⁱⁱⁱ <https://fhmtg.com/product/specialty-financing/non-warrantable-condos>

^{iv} <https://www.fitchratings.com/research/structured-finance/affordability-loans-drive-non-qm-rmbs-higher-expected-losses-27-02-2023>

^v <https://legiscan.com/MD/text/HB107/2022>

^{vi} <https://www.wmar2news.com/homepage-showcase/residents-of-coldspring-newtown-voice-concerns-over-increased-hoa-fees>

^{vii} <https://millmanland.com/company-news/land-surveyor-in-maryland/>

^{viii} <https://www.wtwco.com/en-us/insights/2024/07/managing-residential-and-condo-risk>

^{ix} Maryland HB 1262 exempts HOAs with six or fewer units from reserve study requirements *in counties other than Montgomery and Prince George's counties*. See: mgaleg.maryland.gov/2024RS/fnotes/bil_0002/hb1262.pdf

^x <https://cowielawgroup.com/10-year-contractor-statute-of-repose-and-developer-liability-for-maryland-condominium-and-hoa-construction-defect-claims/>