

Apartment Ownership and Mortgage Finance in Lithuania

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Introduction

The Government of Lithuania has requested World Bank assistance in preparing a housing sector strategy and a loan to support the implementation of the strategy (“the Housing Project”).

The functioning of the housing market depends fundamentally on the ability of mortgage holders to collect on their claims on individuals and housing associations, and on housing associations to collect on their claims against individuals for maintenance and operation of buildings.

The World Bank and the Government of Lithuania decided, as part of the Housing Project, to co-operate with Nordic and Lithuanian legal experts to review legislation and enforcement in Lithuania related to mortgage finance and housing associations.

The implementation of this particular part of the Housing Project was made possible by a grant from the Nordic Council of Ministers. The World Bank and the Government of Lithuania are also contributing to the funding of the project. The project team is referred to as “the working group” in the report.

Apartment Ownership Models and Similar Legal Institutes

In principle a distinction can be made between *indirect* and *direct ownership* of flats. Indirect ownership applies when an association of some kind owns the property, whereas direct ownership applies when the individual flats are owned by the inhabitants (*individual ownership*) or the property is held in co-ownership with a right of use for each co-owner. The distinction on the whole matches the distinction between co-operatives and condominiums in English terminology. In the direct ownership models a *housing association* is often found. This is an association of the owners of the property, but – contrary to what is the case in the indirect ownership model – the association is *not an owner* (formal or real) of any part of the property. The association is just a vehicle for organising the owners of the property.

The distinction between indirect and direct ownership is important when it comes to financing maintenance and other common measures. The co-operative (company, etc.) may take a loan, and the loan may be secured by a mortgage on the entire property. Each apartment owner may in his turn sell or mortgage his apartment, or rather his net share of the co-operative, including his right of use of the apartment. It is obvious that the value of each apartment will depend on the financial situation of the co-operative. A heavy loan burden on the part of the co-operative means high costs for each owner and reduces the value of the apartment. For directly owned

dwellings the main rule is that neither the entire property nor the common parts of the property can be mortgaged.

It is common practice in Lithuania that in multifamily houses separate apartments belong to individual owners and not the housing company. In the terms presented in above this is *direct* and *individual* ownership. – For a description of Nordic models, refer to the report.

Under Lithuanian Law the owners of apartments and other premises have common partial ownership, i.e. common ownership with defined shares (parts) of such ownership, to common usage premises of the house (e.g. lobby, staircases, etc.), basic structures of the building (basement, roof, etc.), mechanical, electrical, sanitary-technical and other equipment (elevators, heating system, inlet piping, electricity wiring, etc.) of common usage.

Owners of apartments and other premises are obliged to pay a proportional part of expenses to upkeep and maintain the building, pay taxes, levies and other contributions as well as regularly make contributions to accumulate funds necessary for refurbishment of the house.

Mortgaging and transactions concerning the common partial ownership in multifamily apartment houses is possible only in the rather special cases where some parts of the property can be separated as distinct units, for example premises on the ground floor of the building not necessary for use by the occupants.

Lithuanian law gives each owner the right to demand of other owners that 1) an association of owners is set up or 2) that an agreement on joint activity is made amongst the owners. In the absence of these two options, an *administrator* may be appointed for the administration of the common property.

Decisions and costs

The owners of apartments in multifamily houses are very much interdependent when it comes to the maintenance of the building and other common parts of the property. There must be rules for deciding what can be *allowed* to be done with the property against the will of one or more of the owners.

There is a broad variety of possible actions concerning the common parts of the property. Roughly one can discern three groups:

- *Urgent* measures, for example stopping a leak from a broken pipe, etc.
- *Necessary* running and maintenance, that constitutes the fulfilment of duties against third parties (taxes, insurance) and actions necessary to upkeep the existing standard of the property
- *Upgrading* measures and introduction of *new facilities*; for example the installation of an elevator.

Under Lithuanian law the state and the municipalities, by establishing mandatory common property usage and maintenance requirements in the multi apartment buildings define the measures that can be required by the municipality or the state through the administrators. Furthermore, according to Lithuanian law each owner has the right to

- Take all necessary measures without the consent of other owners (users) in order to avoid damage and eliminate threat to the common usage property and require from the owners of apartments and other premises to compensate the related expenses in proportion to the share of such owners in the common ownership; and

- Require from other owners (users) of the apartments and other premises that upkeep and usage of common property meet the common rights and valid interests of the owners of the apartments and other premises. For this purpose the valid interests owners of of apartment and other premises are the following: establishment of the internal order rules; proper upkeep and maintenance of common usage property, preparation of action plan and financial plan for maintenance of the dwelling house and accumulation of funds for refurbishment of common usage property.

These rules, although not specific enough, provide for sufficient legal ground to take actions by each individual apartment owner concerning the essential matters of upkeep and maintenance of the multifamily building irrespective of whether there is a multifamily house owners' association in the building or not.

Measures can also be decided by a simple majority vote amongst the owners under certain preconditions stated in the Civil Code (Art. 4.85).

Mortgages and Liens in Apartments and Apartment Buildings

Mortgage in this report means a security right in property created by contract allowing the creditor (the mortgagee, the mortgage holder) to have the property sold in case of default. *Lien* in this report means a security right in a property based on statutory regulation allowing the creditor (the lien-holder) to have the property sold in case of default. The lien – as the expression is used here – is a right in the property of the same kind as a mortgage. The main difference is that a mortgage is based on contract, while a lien is based on statutory regulation. Also the priority of the lien is established by statute, and the lien often has best priority. The lien system for securing the claims of the association of owners against the individual owners is widely spread in Western legal systems.

In Lithuania, since apartments in most cases are identified as separate items of the property, owners of such apartments may mortgage their property without the consent of the other apartment owners. Housing lending against mortgage of individual apartments is a prevailing form of financing in Lithuania. The possibility to mortgage apartment buildings and/or common property is limited. As already indicated, mortgaging of common property is not practical.

Lithuanian legislation does not provide for a lien. However, the Lithuanian Civil Code contains rules on mandatory mortgage, which has the same effect as the voluntary mortgage in securing obligations. Mandatory mortgage is based on statutory provisions or a court decision only, not on the agreement between the parties, as is the case with voluntary mortgage. More precisely, the mandatory mortgage is the right of the creditor to require the debtor to mortgage his property to secure certain claims of the creditor. Lithuanian law does not provide for a clear possibility to create a mandatory mortgage to secure the claims of the co-owners of multifamily house, the housing association or the administrator of the multifamily building.

Protection of Dwellings against Creditors

The main rule in the Nordic countries is that creditors may seek satisfaction of their claims in the debtor's apartment. Some property may be protected from creditors, but this does not apply when it has been used as security for a loan.

In Lithuania according to the Civil Code, the spouse with whom minors are left, may be granted by the court the right to reside in the family estate or any part thereof until the minors reach majority age, thus encumbering the living premises and making enforcement from such living premises very problematic.

The Law on Protection of Child's Rights provides for certain guarantees to a child, which *i.a.* includes the child's right to a dwelling. Orphans or children without custody and care of parents shall not be evicted from their dwelling without providing them with a comparable dwelling.

Present Lending Practices

In the Nordic countries ordinary maintenance and repair works in multi-apartment houses in direct ownership can normally be covered by the monthly payments from the apartment owners. The monthly payments should be stipulated in a budget (financial plan). Otherwise, maintenance and repair can be financed by a) levies on the owners, b) a loan to the association without security or c) with security in the apartments. In addition to this a mortgage holder must respect a lien on the apartment securing the payment of common costs (Norway) or a mortgage in favour of the housing association regarding the same type of costs (Denmark). The impression is that the liens or mortgages for common costs do not cause severe difficulties for ordinary mortgage lending.

In Lithuania lending to housing associations for renovation of the existing multifamily houses is almost non-existent. Local banks merely act as administrators of funding provided by the Government and/or multilateral financial organisations. As a general rule, in such cases, no mortgage of the individual apartments or the whole dwelling house is required.

Discussion of Reforms and Recommendations

The social laws of Lithuania that in some situations *protect debtors from eviction* are dealt with in Chapter 5 of the report. It is not possible to say yet exactly how the relevant provisions will be practised. In the working group's opinion, however, the rules can be practised in a way that will not substantially hamper normal lending or the activities of housing associations. It should be noted that protection against debt collection, including forced sale and eviction, cannot be upheld in the long run as far as debts from ordinary housing costs are concerned. That is the view underlying also the legislation in the Nordic countries. Where moving to a less expensive dwelling is socially unacceptable – the reason being that moving in itself is an unreasonable burden or that a lower standard is not justifiable – the answer should be some kind of subsidies or social security benefits.

The working group has noted the recent *decision of the Constitutional Court* stating that membership of a housing association cannot be made mandatory. Such a standpoint seems paradoxical. Any owner who prefers to remain outside the housing association will still have to pay the costs of necessary upkeep and repairs, as it is provided by the Civil Code enacted after adoption of the Constitutional Court ruling. In fact such an owner is left without influence in these matters, but still liable to pay.

In Lithuania, availability of loans for maintenance and operating of apartment houses will *depend very much on the extent to which a lender can have a claim against each owner*, either directly or as a result of assigning and/ or pledging the association's claims against the owners. As a consequence the availability and costs of the credit will also depend on the *creditworthiness of the owners*. The housing association will normally have only small assets

apart from the claims against the owners. The administrator will normally not be a party to loans or other contracts.

The working group recommends the *introduction of a lien system* in Lithuania. The great advantage of a lien system is that it permits the housing association to take a loan in its own name, but being perfectly sure that it is able to repay the loan, even if the individual owners are not willing to pay after a resolution by the association to levy the members for purposes of repayment. The experience of both Norway and Sweden has been that the advantage of having the property properly kept increases its value, something from which also mortgage holders benefit.

There is a number of alternatives, although perhaps less attractive. One possibility is a system whereby the *room for mortgaging the individual apartment is statutorily limited*, so that the owner is able to mortgage the first say, 15 percent of the value of the flat only in favour of the association.. In this way it seems to be possible to avoid introducing a new security right; an ordinary mortgage is given. – This solution with a reserved priority, however, may be technically somewhat difficult to carry out.

A second possibility is to provide the claim of the owners against other owners or the claim of the housing association with a *general priority* in connection with the property of the owner. The system of general priorities in relation to property in Lithuania is caused by the rule that natural persons cannot go into bankruptcy.

Under current Lithuanian law, *mandatory mortgage* may be imposed upon the request of the claimant in certain cases. There are a number of limitations to mandatory mortgage. There is a risk of disproportion concerning the debt and the consequences of the individual, which requires a limitation in the sense that the object under mandatory mortgage should not be more than enough in order to satisfy the claim. This means that under Lithuanian law chattel security may be preferred if the claim is not very big. However, the working group maintains that there are obvious advantages in using the apartment as the object of forced mortgage.

Another possibility, which does not require immediate legislative intervention, is to introduce a *mortgage system based on contract* for loans taken by the housing association much along the lines of the Danish system described in subchapter 4.1.1 of the report. The Danish model is based on a system whereby at the formation of the common ownership the founders draw up documents stipulating that a certain proportion of the available mortgages with best priority of each apartment is to be given to the housing association as security for future debt incurred by the association for upkeep and repairs, etc., and its consequent claims against the owners of the apartments – the members of the associations. The Danish system is complex and has to be thought over carefully if it is to be fitted into the Lithuanian situation. The primary difficulty is the fact that such a system is difficult to introduce into existing co-ownership.

Regardless of what solution suggested in the foregoing sections is considered by the Lithuanian government, one may always consider combining it with some measure of *credit guarantee* for loans to housing associations. The working group is aware that is an option contemplated by the Lithuanian Housing Project and will not discuss this question further.

It is imperative to *reduce the risk of disputes* concerning to what extent each owner has a duty to pay for maintenance and operation of the property. To this end the various provisions on management of apartment buildings should be co-ordinated and clarified. It should be made clear that the duty laid down in the Civil Code for each owner to pay for maintenance etc. comprises the actions necessary to upkeep the existing – or original – standard of the property, and that this duty also corresponds with the actions that can be decided by an appointed

administrator. The efforts already laid down in defining the content of necessary maintenance and operation of the building are endorsed by the working group. The working group further recommends that a state or municipal agency be authorised to make advance decisions on whether or not particular plans of maintenance measures are within the powers of an administrator, a housing association or the majority of owners. An advance decision should be presumed correct until it is established without doubt that the decision of the agency be wrong. This recommendation implies an amendment of laws and other secondary legislation. It should also be made clear that it is the responsibility of a housing association or an appointed administrator to take out insurance for parts of the property that are not covered by individual insurance.

Model agreements of joint activities among apartment owners should be issued by the authorities or by organisations to guide the owners and to encourage them to establish this form of management where it is appropriate.

Schemes of reverse mortgages or state or municipal loans backed by mortgages in the apartments should be considered for cases where the owner cannot afford to pay his share of the common costs, the idea being that the capital vested in the apartment should be made liquid even if the owner is unable to pay ordinary loan instalments.