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THE FINANCING OF COOPERATIVES AND CONDOMINIUMS: A RETROSPECTIVE

RICHARD J. KANE

In real estate it is rare indeed to witness an entire area of specialized practice evolve from embryonic stage through maturation. Yet, with respect to American condominium law, many of us have had that opportunity.

Although some commentators trace the concept of the condominium to ancient Rome,\(^1\) it is more generally accepted that the concept was introduced in Europe during the twelfth century.\(^2\) One of the earliest identifiable statutory recognitions of the condominium is found in the Napoleonic Code of 1804.\(^3\) The

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\(^2\) See John E. Cribbet, Condominium—Home Ownership for Megalopolis?, 61 MICH. L. REV. 1207, 1210 (1963) (discussing the recorded history of the condominium in twelfth century German cities and during the Middle Ages in France and Switzerland).

\(^3\) "Article 664 of the Napoleonic Code, which dates from 1804, refers to the repair and reconstruction of a building whose different floors belong to various proprietors." Berger, supra note 1, at 988 n.5. Article 664 specified the maintenance
first sophisticated U.S. condominium statute was enacted in 1958 by the Commonwealth of Puerto Rico. Some states thereafter enacted similar statutes. Initially, there was little to indicate that this innovation would become popular. However, with the enactment of § 234 of the National Housing Act in 1961, the Federal Housing Administration ("FHA") was authorized to insure mortgage loans secured by condominium units in those states that had enacted condominium laws. Because "FHA financing" as it is commonly called (although it is more accurately described as "FHA-insured financing") was at that time one of the most popular means of financing the purchase of a home, the creation of § 234 was critical to the growth of the condominium form of ownership. Primarily because of the FHA imprimatur, by 1969 every state in the United States had adopted legislation authorizing condominium regimes.

Although the concept of the cooperative form of ownership appears to have a shorter overall history than the concept of the condominium, the cooperative form of ownership of real estate has been around the United States for a much longer period of time than the condominium, first appearing in the United

responsibilities when different owners shared floors, staircases, and roofs. See William K. Kerr, Condominium—Statutory Implementation, 38 St. John's L. Rev. 1, 3 n.7 (1963).


5 See Richard R. Powell, Powell on Real Property § 632.2[3], at 54-37 (Patrick J. Rohan ed. 1998) (noting that other states soon followed Puerto Rico's lead, and within ten years, all other jurisdictions, including the District of Columbia and the Virgin Islands, had some type of a condominium statute); Sweat, supra note 4, at 129 (stating that many states patterned their condominium statutes on the 1958 statute and that, in 1962, the Federal Housing Administration promulgated a Model Condominium Statute, which also served as a framework for many states). New York enacted its Condominium Act in 1964. The Uniform Condominium Act, however, was not developed until 1977.


7 See Kerr, supra note 3, at 1 ("Section 234 is directly responsible for the advent of [the] condominium in the continental United States."); Marketing Report: Condo Starts Soar From Coast to Coast, 1 Condominium Rep., May 1973, at 3-4.

8 See 7 Powell, supra note 5, § 632.2[3], at 54-35.

9 See Patrick J. Rohan, Real Property § 9.01, at 9-1 (1981). First becoming important after World War I, cooperatives are a relatively new type of housing. Still, co-ops have a longer history than condominiums, which were widely created
States in the second half of the nineteenth century.\textsuperscript{10} It has been suggested that the cooperative concept is Finnish in origin.\textsuperscript{11} The cooperative form gained popularity in response to the housing shortage that followed World War I and in response to the rent control statutes that followed World War II. Early cooperatives were also popular because that form of ownership allowed wealthy apartment dwellers to decide who lived in their buildings. The first examples of cooperative ownership were found in New York City.\textsuperscript{12}

Notwithstanding the earlier start that the cooperative concept enjoyed in the United States, that form of ownership never developed the widespread appeal that the condominium form of ownership was able to generate. Today, the cooperative form of ownership remains most prevalent in New York and Chicago.\textsuperscript{13} Cooperatives are also found, albeit with less frequency, in Los Angeles and San Francisco, and parts of Florida,\textsuperscript{14} however, the

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\textsuperscript{10} See id. Thus, when compared to condominiums, more accurate predictions as to the future of cooperatives are possible. See id. The use of cooperatives in this country actually dates back further, to the late nineteenth century. See 15A AM. JUR. 2D Condominiums and Cooperative Apartments § 61 (1976).

\textsuperscript{11} The earliest reported American case involving a cooperative apartment arose in 1886, Barrington Apartment Ass'n v. Watson, 38 Hun 545 (N.Y. 1886). There, plaintiff corporation constructed apartments to be owned and occupied by its original projectors and stockholders. Defendant lessee sought to sublet, notwithstanding a lease provision prohibiting such subleasing without written consent. The court granted plaintiff's injunction, prohibiting an unapproved sublease. See 15A AM. JUR. 2D § 61, at 891 n.85.

\textsuperscript{12} See Edward M. Ross, Condominiums in California—The Verge of an Era, 36 S. CAL. L. REV. 351, 352 (1963) (stating that today's prevalent form of corporate ownership, which utilizes corporate stock and long-term leases, is of Finnish origin); see also Chester C. McCullough, Jr., Co-operative Apartments in Illinois, 26 CHI.-KENT L. REV. 303, 304 (1948) (discussing the history of the general cooperative housing concept).

\textsuperscript{13} See Berger, supra note 1, at 991-92 n. 25; McCullough, supra note 11, at 305; Ross, supra note 11, at 352 (noting the success of the cooperative during the 1920s and the post-W.W.II era).

\textsuperscript{14} See 7 POWELL, supra note 5, § 632.2[2] at 54-34. However, the condominium remains more popular in other parts of the country; cf. Stewart E Sterk, Minority
cooperative form of ownership is not employed in many parts of the country, including many large cities. The early history of the financing of the condominium and cooperative forms of ownership in the United States followed very different tracks, although today, the financing of these diverse forms of property ownership has become more parallel.

I. CONDOMINIUM FINANCING

A. The Early Days

The middle to late 1960s marked the real emergence of the condominium form of ownership in the United States. In those days, the basic concepts for real estate financing were simple and traditional. Construction loans were provided to finance the construction of residential buildings. Construction loans were typically provided by commercial banks at 1% to 1.5% in excess of the prime rate, which in 1966 stood at 6% per annum. Savings banks provided long-term financing (then referred to as a "permanent loan") for smaller projects, and insurance companies financed larger projects. Those permanent loans were typically self-amortizing with terms of twenty-five or thirty years and

Protection in Residential Private Governments, 77 B.U. L. REV. 273, 276 (1997) (citing the Community Associations Institute's estimate that in 1990, there were 4,847,921 condominium units in the United States and 824,000 cooperative units).


In the 1960s, the principal providers of long-term commercial financing were insurance companies. Following the disastrous experience of lenders during the Great Depression, self-amortizing loans became the solution to the Depression-era problems. Prior to the Depression, "long-term" loans were not very long term, having terms of five or seven years. Those loans were made as interest-only loans, meaning that during the term of the loan, the borrower was required to pay only interest (most commonly on a monthly basis) and was required to pay the entire principal at maturity. Historically, those loans were "rolled over" at maturity, meaning that the lender simply renewed the loan for a new five or seven-year term. When the Depression hit, the banks were faced with staggering withdrawals and, therefore, no longer had the deposits to enable the banks to renew the loans. When the lender demanded repayment of the matured loans, the borrowers, with no other source of loan proceeds to replace the loan, had no choice but to default. It was thought that the solution would be to require that loans be made on a self-amortizing basis so that at maturity no principal payment would be required. Insurance company loans were strictly regulated and, in the 1960s, the typical statute
were provided on a fixed-rate basis with interest hovering at about 6% or 7% per annum.

The residential condominium broke the traditional financing mold for single-building financing. Although the concept of the construction loan remained the same, the construction loan would not be paid off through the funding of a permanent loan, but rather repayments of the construction loan would be derived from sales proceeds as the condominium units were sold.\(^{17}\) Individual unit purchasers could obtain financing from savings banks and savings and loan associations ("S&Ls") on a typical home loan basis.\(^{18}\) In many respects, this form of single-building financing paralleled the financing of large tract developments of single-family homes. However, the owner of a single-family home did not have the added complexities that burdened the owners of the units in a multi-unit condominium building. These included owning a home stacked atop and between other homes, being dependent upon other homeowners for support, utilities and access, being tied to an owners' association for maintenance, insurance, reconstruction, or repair of common areas, for assessments for common area expenses, and having to face the then ever-present recreation lease, to name a few.\(^{19}\)

The condominium first flourished in Florida. The original vision of Carl Fisher\(^{20}\) of Miami Beach as a vacation homeland

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\(^{17}\) See PATRICK J. ROHAN, REAL ESTATE FINANCING § 15.09[4][a], at 15-288 (1998).


\(^{19}\) For a discussion focusing on the privacy and independence problems facing unit owners, see Aaron M. Schreiber, The Lateral Housing Development: Condominium or Home Owners Association?, 117 U. PA. L. REV. 1104, 1134-53 (1968).

\(^{20}\) Carl Fisher was a truly fascinating, "Horatio Alger" figure. He was raised by his mother after her alcoholic husband abandoned the family. He was considered the "most stupid boy" in school, and had difficulty walking, primarily because he was "half-blind" with an astigmatism. He dropped out of school at the age of twelve to peddle newspapers on trains. His flare for promotion led him to become Indiana's most successful automobile dealer through such publicity-grabbing stunts as riding a bicycle across a tightrope twelve stories above the street and drifting across the business district of Indianapolis in a white automobile hung beneath a vermilion-colored balloon. He convinced the leaders of the automotive industry to finance the first paved road across the country, the Lincoln Highway from New York to San Francisco. Others called him a "crackpot" when he persuaded three partners to help him build the Indianapolis Speedway, but his wildest scheme was to take a mosquito-infested swampland in southern Florida and turn it into Miami Beach. Using
for wealthy Northerners had long since given way to rows of hotels, middle-class residences and commercial buildings to service the needs of a growing population.\(^2\) By the mid-1960s, many of the early hotels in the southeast portion of Miami Beach (the South Beach area) had become run down, single-room retirement residences. Nevertheless, Florida had become the nation's favorite retirement location. Hundreds of thousands of retiring Americans were selling homes in the North to seek their retirement homes in the "Sunshine State."\(^2\) Developers recognized that they could take the concept of the apartment complex, or a more modest version of the Levittown\(^2\) private home develop-

special equipment imported from his native Indiana, he cleared what land there was and dredged Biscayne Bay to create the main island of Miami Beach and many of the islands on the beach side of Biscayne Bay. When he was unsuccessful in attracting wealthy business people to adopt Miami Beach as a vacation land, he brought in an elephant and bathing beauties to promote his dream. Northern newspapers continuously published stories about the island with pictures of the elephant and the young ladies, and shortly thereafter Miami Beach (and ultimately, Florida) became the dream of vacationers and later of retirees throughout the United States. Carl Fisher lost his fortune while trying to promote Montauk, New York, as the Miami Beach of the North. The value of all of his holdings plummeted with the unsuccessful Montauk venture and a hurricane that seriously damaged Miami Beach. The market crash of 1929 wiped out the balance of his fortune. He died in poverty in 1939, living alone in a small house on a side street in Miami Beach. See Steve Hall, Dredged-up Dreams: Hoosier Carl Fisher Brought His Plan for Miami Beach Up from the Bottom of Swampland (Jan. 29, 1998) <http://speednet.starnews.com/speednet/indycar/98/an/0129SN_fisher.html>.

\(^{21}\) See Salvatore LaMonica, Note, Developer Leases Under the Condominium and Cooperative Relief Act of 1980, 15 HOPSTRA L. REV. 631, n.2 (1986) (noting that Florida saw growth in both the 25 to 34 year-old age group as well as the over 65 age group, and that both groups found condominium style living desirable).

\(^{22}\) During the 1960s and the early 1970s, the author of this article represented the construction lender on over 30 condominium construction loans in Florida alone. See John A. Cutter, Retirement By the Numbers Series: Tales From Retirement, ST. PETERSBERG TIMES, Mar. 22, 1998, at 4F (noting that Florida is the most popular retirement spot, for those who move, from 1960 through 1990; retirees came primarily from the northeastern and midwestern states of New York, New Jersey, Michigan, Ohio, and Pennsylvania); LaMonica, supra note 21, at 631 n.2. See also Alan S. Oser, Part-Time Floridians Influence Building, TAMPA TRIB., Feb. 2, 1997, at 1 (stating that in many parts of Florida, much of the population is "seasonal"; condominiums have become the "motels" of short-term visitors, who initially came for the low property costs, investment value, and recreational activities).

\(^{23}\) At the end of World War II, twelve million American G.I.'s came home to live in attics, basements and Quonset huts. William Levitt, an entrepreneur from a family that had been building high-end housing on Long Island's North Shore (known as the "Gold Coast"), spear-headed an extraordinary venture. In 1947, the Levitt family purchased 7.3 square miles of potato farm land in an area known as "Island Trees" in Nassau County, Long Island, New York. Employing the Henry Ford production line method of constructing simple homes, the Levitts were able to
ment, and enhance that concept with modest recreational facilities (in most cases). They could then sell the units for a quick initial profit and take back a recreation lease with escalations to ensure a continuing long-term profit.\(^{24}\)

The sale of the units allowed the developers of the condominium facilities: (a) to pay off their construction loans; (b) to recover all of the developer's own investment in the project (which, in most cases, was precious little), with none of the liabilities and responsibilities incurred by their brethren who retained ownership of multi-family residential projects and who relied on rent for their long term (and only) profit; and (c) in most cases to make a handsome immediate profit from the balance of the sales price.

The recreation lease created a permanent annuity, without imposing any responsibilities whatsoever on the developer who, although retaining the nominal position of landlord under the recreation lease, for all practical purposes, transferred the ownership and the maintenance responsibilities for the recreational facilities to the condominium board. The unit owners basically paid cash for their units (although in most instances the bulk of the cash paid to the developer was supplied by the unit owner's

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\(^{24}\) See John R. Lewis & Kenneth A. Jessell, The Condominium Recreation Lease Controversy, 9 REAL EST. L.J. 7, 7-8 (1980) (observing that developers could charge unreasonably high fees for use of maintenance facilities, which escalated over cost of living increases, and then demand excessive buyout prices); Lisa A. Steinhardt, Note, Unit Owners' Ability to Cancel Contracts Under the Condominium Act, 54 BROOK. L. REV. 589, 589-91 (1988) (observing that the Congressional intent behind the Condominium and Cooperative Relief Act of 1980 was to curb abuse by allowing purchasers to terminate unconscionable contracts).
lending institution), paid maintenance to the condominium association for the upkeep of the condominium's common facilities and paid the recreation lease rent to the developer for the right to use the recreational facilities that the unit owners had essentially already purchased. To add further insult to that injury, in virtually every recreation lease, the rent escalated with increases in the Consumer Price Index.25

B. The First Boom

Many of the developers who climbed aboard the gravy train in the early days of condominium development sought financing from large commercial banks in the northeast United States. Lenders initially had significant concerns as to whether this "new-fangled" form of ownership would gain market acceptance among the intended customers for this new residential product.26 To defend against the risk that the condominium units might not sell, lenders imposed rigid pre-sale conditions to the loans. It was not uncommon in most construction loans for lenders to require that the developer pre-sell fifty to seventy-five percent of the residential units before the lender would fund the first dollar of the construction loan.

The developer would acquire the land, sometimes with the aid of a land loan, and construct a few model units. In the case of the Levittown-type development, four or five model homes and sometimes a recreational building or a clubhouse, would be con-

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25 See Barry A. Mandelkorn et al., The Non-Unconscionability of Condominium Recreational Leases, 34 U. MIAMI L. REV. 563, 567-68 (1980) for a discussion on the impact such leases had on unit owners. The Consumer Price Index ("CPI") is commonly used as a method for increasing or escalating streams of payment, including items such as rent. Generally, the formula employed in most rent escalation provisions contemplates that the percentage increase in CPI over a defined period of time (e.g., one year, five years, ten years) would result in an identical percentage increase in the rent. Thus, for example, in a lease that has a CPI rent increase every five years, if at the end of the first five years of the lease term the percentage increase in CPI was 12%, the rent for the ensuing five years of the lease would likewise be 12% higher than it had been during the first five years of the lease. Typically, the escalation provision would contain a floor so that the rent would not go below a certain level (most commonly, the rent during the immediately preceding period) were CPI to move lower during the measurement period. Cf. Milton R. Friedman, Rent Escalation Under Business and Commercial Leases, 351 PRAC. L. INST. REAL EST. 383, 398 (1990) (asserting that the CPI is not the proper index to be used for rent escalation, because "commodity prices have little relation" to the costs of building operation).

26 See ROHAN, supra note 17, § 15.01.
constructed as the lure during the pre-sale part of the program. The unit purchasers would look at the model homes and buildings and select a lot from a map in the sales office. In the case of the high-rise or mid-rise apartment complex, a small building containing a few typical model apartment-like units would be constructed to entice prospective customers to purchase residential apartment units, after which the models would be demolished to make way for the construction of the apartment building. Despite the initial concerns of the lenders, retirees came in droves to purchase condominium units. These buyers signed contracts for projects that had not yet been started in communities that were no more than sketches on a bulletin board in a sales office. By the early 1970s, nothing in the real estate arena was hotter than the residential condominium.  

The acceptance of the commercial condominium followed fairly quickly on the heels of the residential condominium. Initially, the concept of the commercial condominium was introduced in mixed-use buildings. One of the best known examples of the early mixed-use condominium is the Olympic Tower building, situated next to St. Patrick's Cathedral in New York City. The construction of this 50-story building was commenced in 1969. The first floor of the building is employed for entrances, retail shops, and a restaurant. Floors two through, and including, twenty-three of Olympic Tower are used as office space, one floor is devoted to mechanical equipment for the offices, and the upper twenty-six floors are residential units. The first twenty-three floors of the building collectively constituted a single commercial condominium unit, while each of the residential units was treated as a separate unit. The single commercial unit was then rented in typical office-building fashion, and treated as a separate building from the upper residential floors. The residential units utilized a separate entrance and separate elevators. One of the earliest examples of the all-commercial (in that case, all-office) condominium building was the Blue Cross–Blue Shield Building located at 100 Summer Street in downtown Boston, the construction of which was commenced in 1973.  

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27 See, e.g., Jon Nordheimer, South Grapples With its Success, N.Y. TIMES, Nov. 29, 1973, at 29 (stating “the pace of development and immigration in the last several years [in Florida] has been frenetic”). Economic forces encouraged conversion of rental housing to condominium and cooperative ownership.  
28 The author of this article represented the construction lender in the con-
In the 1960s, condominium developers were generally seasoned real estate veterans. However, by the 1970s, the pool of people developing residential condominiums had expanded geometrically to include many who had never tried development in the past and who had no experience in anything even akin to real estate development. Money had become readily available. Real estate investment trusts ("REITs") had proliferated in the lending landscape and officers at banks and REITs were falling over each other in an effort to pump money out the door. Construction loans were being priced at three and four points above the prime rate, and lenders were more than willing to advance money approaching one hundred percent of development costs (and in a few instances more than one hundred percent). No one seemed to care that the lenders' commitment letter forms still contained pre-sale requirements of fifty percent of the units, because the pre-sale condition was so easy to satisfy. By this time, the construction lenders were making land loans, financing one hundred percent of the developers' cost of acquiring the land as well as financing the construction of pre-sale models, recreational facilities and site improvements. Lenders and developers alike were raking in big profits and the condo purchasers were delighted with their new homes. Everyone was happy.

C. The First Downturn

In 1974, the party came to a screeching halt. During 1973 and 1974, America was hit hard by an oil embargo by the Organization of Petroleum Exporting Countries ("OPEC"). That embargo resulted in an extraordinary escalation in the cost of asphalt, a major component in the construction budgets for large-scale projects.29 The cost of vitreous china, tar paper and construction loans for both Olympic Tower and the Blue Cross-Blue Shield buildings. The Olympic Tower financing was also interesting because it involved one of the earliest financings of "air rights" (transferable development rights) from neighboring properties along Fifth Avenue and the side streets, and involved one of the earliest (if not the first) transfers of prior mortgages (one from a property in Buffalo, New York, to the site) and the assignment of those mortgages to the construction lender to save substantial amounts of mortgage recording taxes.

29 The decision by the OPEC cartel to reduce oil production for political reasons had the effect of substantially increasing the price of a barrel of oil world-wide. Within a relatively short span of time, the price of oil, which had remained at levels under $4.00 per barrel for more than fifty years, suddenly went to $8.00 per barrel, and over the next few years reached a high point in excess of $32.00 per barrel. See WTI Crude Oil Posted Price—U.S. First Purchaser's Crude Oil Price, <http://
asphaltic shingles, among other building products, also spiked dramatically, causing significant cost overruns in all developments, including high-rise condominiums, albeit to a lesser extent because far less asphalt is required for roadways in a high-rise project.\(^3\) Interruptions in the supply and delivery of those materials caused significant delays in the construction of projects. To compound the problem substantially, the prime rate, which had been at 4.75% in 1972, shot up to 12% by August 1974.\(^3\) That increase in the interest rate alone added another $800,000 in interest payments to a typical $10,000,000 project, even assuming the project could be completed on time. Any delay in construction would further increase the interest cost as the meter continued to run. Budgets for condominium projects were in complete chaos. It quickly became clear to the developing and lending communities that condominium units could no longer be built for anywhere near the initially contemplated cost.

Suddenly, the pre-sale requirement, which had been designed to ensure the project’s success, now guaranteed its failure. Having pre-sold almost all of the units in the project, developers found that they could no longer build those units for the prices at which those units had already been pre-sold. Since the beginning of the 1970s, developers had been investing virtually none of their own money in condominium projects. Now, with construction costs greatly exceeding the money available from construction loans, developers could finish projects only if they were willing to pour in substantial sums from their own personal financial resources. Those personal funds could never be recovered because the units had been pre-sold at prices that would not even cover the construction loans now carrying bloated interest costs. With virtually nothing of their own to lose, and nothing to gain by dumping portions of their personal fortunes into the pro-

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\(^{30}\) See, e.g., GAF Raises Roofing Prices, WALL ST. J., Apr. 1, 1975, at 7 (stating that GAF corporation increased the price of roofing products due to “recent rash of prices increases for asphalt?”); Richard W. Duesenberg, Sales, Bulk Transfers, and Documents of Title, 38 BUS. LAW. 1109, 1113 (1983) (noting that in January, 1974, Shell Oil jumped its asphalt price from $44 to $76 per ton). OPEC was not the only problem. See Plumbing Concerns Settle U.S. Charge, N.Y. TIMES, Apr. 16, 1971, at 74 (discussing Justice Department’s proposed settlement forbidding price fixing of vitreous china plumbing fixtures, by eight major plumbing manufacturers accused in civil antitrust suit).

\(^{31}\) See Federal Reserve Prime Rate Website, supra note 15.
verbial "rat-hole," developers simply defaulted on their construction loans and walked away from their unfinished projects. Lenders, reluctantly at first, but later in droves, foreclosed on incredible numbers of unfinished condominium projects.32

The foreclosing lenders then had a choice of completing the project at a substantial loss or simply abandoning it. Unit purchasers who had signed contracts for unfinished units commonly lost their deposits, because at that time there was no requirement that the developer hold those deposits in escrow.33 In order to keep interest costs down, even when the prime rate was only 4.75%, the developer generally delayed the need to draw down construction loan proceeds (on which the developer paid interest) by plowing the unit purchaser’s down payment money into construction as soon as the down payment was received.

Lenders who foreclosed on the projects and terminated the rights of the pre-sale contract vendees, many of whom had been placed in harm’s way by the bank’s pre-sale requirement, suddenly found a new problem. Although the number of people wanting to retire and move to the retirement projects of the sunny south did not diminish, the number of those who were financially able to do so dropped dramatically. The phrase usually used to describe this problem was “disintermediation of funds.”34

With interest rates rising dramatically, the American public was pulling its money out of savings banks and S&L’s and putting that money into high-yield instruments.35 The savings

32 See B. Drummond Ayres, Jr., Assorted Ills Plague Florida’s Condominium Market, N.Y. Times, Dec. 17, 1974, at 20. Estimates indicated that of 900 construction projects under construction, one in three faced bankruptcy or deep debt. See id. During this downturn in real estate, the author of this article foreclosed on construction loans on behalf of construction lenders throughout the United States, including several condominium projects located in Florida. The author also represented construction lenders in many “workouts” of condominium construction loans all around the country, many of which related to Florida projects.

33 Today, several jurisdictions have statutes requiring developers of residential construction projects to hold unit down payments in escrow. See, e.g., FLA. STAT. ANN. § 718.202 (West 1988); HAW. REV. STAT. ANN. § 514A-67 (Michie 1985).

34 See BARRON’S DICTIONARY OF BANKING TERMS 150 (3d ed. 1997) (defining “disintermediation” of funds as the “withdrawal of funds from interest-bearing accounts when rates on competing financial instruments, such as money market mutual funds, stocks, bonds, and so on, offers the investor a better return”).

35 See Arthur F. Burns, Statement Before the Committee on Banking and Currency, Sept. 12, 1973, 59 FED. RES. BULL. 658, 659 (1973) (noting that signs of developing problems in housing finance became evident early in 1973 when the inflow of consumer savings to commercial banks began to shrink, making lenders less eager and subsequently causing increased interest rates on mortgage loans).
banks and the S&L's, which had been the traditional sources of home loans, suddenly found themselves without cash and, therefore, unable to make more loans. The net result was that would-be retirees could not sell their homes in the north because the prospective purchasers for those homes could not obtain mortgage financing to do so. Even when those retirees were able to rid themselves of their real estate obligations in other parts of the country, loans were not available for them to purchase the units owned by the banks in retirement locations. Prospective purchasers were out of the market unless they were willing to purchase their retirement homes on an all-cash basis.

Lenders who completed the construction of condominium units would then have a difficult task selling those units, and were facing the prospect of holding them for a fairly long period of time. Adding to this dilemma, Section 29 of the National Bank Act further imposed a requirement that national banks (then the major source of construction loans) dispose of real estate acquired by foreclosure within five years of the acquisition of that property. Holding the property for a long period of time was not a legal option. The lenders were faced with other pressures too. Wall Street was demanding that the banks write down their loan portfolios, take charges, and dispose of the foreclosed property as quickly as possible. Most banks booked those losses as quickly as they could be quantified. In most cases, the write-downs were severe, and in many cases to exaggeratedly low values.

Lenders sought solutions in various ways. In many instances, the banks hired developers to complete the construction of the foreclosed projects and to sell them on behalf of the banks, often at deep discounts. In other instances, lenders sold the foreclosed projects to favored developers at deep discounts, and the same banks loaned those favored developers nearly one hundred percent of the cash necessary to acquire the project from the bank. Since the loans had been written down so severely, the value of the defaulted loans (or real estate that the bank had ac-

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37 See id. However, a national banking association can hold the real estate for more than five years if the association applies to the Comptroller of the Currency, and can establish that the association made a good faith effort to dispose of the real estate within the initial 5 year period and disposal of the real estate within the initial five year period would be detrimental. See id. But under no circumstances may the time period exceed an additional five years. See id.
quired at foreclosure of defaulted loans) appeared on the books of the bank at far lower values than the true values of those loans (or that real estate), even under the depressed market conditions that existed at that time. As a matter of creative bookkeeping, the banks booked a "profit" on the sale of the loans or the foreclosed property because the sale (even at bargain discount prices to favored developers) resulted in sales prices that were significantly higher than the book values that had resulted from the write-downs. As a second "benefit" to the banks, a bank that loaned money to those developers who (literally) took the project from the bank was then able to show that the purchase-money loan it had advanced to achieve its "profit" was then a performing loan on its books. As a result of this creative bookkeeping, banks were showing significant "profit" on real estate transactions and loans, even though the real estate market was still in the doldrums, and even though the banks were practically giving valuable real estate away. And, of course, senior management at many banks vowed that they would never again be involved in real estate financing!

D. Round Two

As market conditions began to improve toward the end of the 1970s, a few lenders began to venture back into the world of real estate financing. As is always the case in the early recovery phase of the real estate cycle, the lenders insisted that all real estate financing would be underwritten conservatively and administered with great care. And so it was as other lenders watched their braver competitors safely making profits in real estate, they too gradually moved back into the marketplace with conservative practices. However, by this time, banks had

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8 A "write down" is an accounting method used to allocate losses on a balance sheet, by transferring "a portion of the balance of an asset to an expense account due to a decrease in the value of [the] asset." BLACK'S LAW DICTIONARY 1609 (6th ed. 1990).

39 There was an unprecedented boom in the real estate market in the 1980s. See Alex E. Sadler, Note, The Inherent Ambiguity of Commercial Real Estate Values, 13 VA. TAX REV. 787, 787 (1994). "Between 1980 and 1989, lenders financed and developers built approximately 5.38 billion square feet of office space—about as much as was standing in 1979." Id. at 788. S&Ls also took advantage of the 1980s opportunities by making profit-sharing and equity participation loans in commercial real estate. See Clifford L. Fry & Donald R. House, Economic Issues in the Defense of Directors and Officers of Financial Institutions, 110 BANKING L.J. 542, 548 (1993) (describing the shift in lending from commercial to residential real estate).
downsized or totally eliminated the real estate departments that they had grown in the late 1960s and early 1970s. The new lending officers that would be introduced to the real estate market during the recovery phase had no experience with the problems that led to the market collapse at the end of the previous real estate cycle. Consequently, as the market heated up again, these new lending officers, with no downside experience, were destined to face similar problems at the inevitable end of the upcycle that their counterparts had faced when the balloon burst in the mid-1970s.

As the 1980s began, real estate again became a hot market. Building "values" continued to rise dramatically and lenders again began to compete for the opportunity to finance projects that were rapidly becoming overpriced. At this point, the financing of condominiums and cooperatives began to merge.

II. COOPERATIVE FINANCING

The Early Days

If, in the early stages of the condominium era, lenders found that loans to the owners of condominium units were unusual, in the early days of cooperative financing, they found that loans to the "owners" of cooperative apartments were downright odd. In the case of condominiums, at least the lenders were dealing with security interests in real estate. The "owner" of a cooperative apartment, on the other hand, does not "own" the unit, but rather purchases stock in the cooperative corporation that owns the building. The unit owner then obtains from the cooperative corporation (the owner of the building) a "proprietary lease," which entitles the unit owner to occupy (as a tenant) a particular apartment in the building. While the net effect of the coopera-

40 The "unit owner" of a cooperative apartment, thus, is really a stockholder in the corporation that owns the building, and that "unit owner," who no doubt perceives himself or herself as an owner of the "co-op" or apartment, is no more than a tenant of that space. Thus, "such a person is customarily referred to as a 'tenant stockholder.'" Joel E. Miller, Condominiums and Cooperatives, 16 J. REAL Est. Tax'N 265, 267 (1991). The proprietary lease, for example, "may contain provisions authorizing a termination of all the proprietary leases upon the happening of certain specified events, such as the sale or condemnation of the apartment." 15A AM. JUR. 2d Condominiums and Cooperative Apartments § 65 (1976). A proprietary lease is essential because a shareholder has no right to occupy the cooperative without it. See id.
tive form of ownership is essentially the same as the condominium form of ownership, the legal ramifications are quite different. 41

Initially, financing for cooperative apartments was available only at the "building level" and not at the "unit level." The construction financing of a cooperative apartment building was essentially no different than the financing of a traditional residential apartment building. Although construction loans could have been paid off with the proceeds of the sale of shares in the cooperative apartment building, historically the construction loans were either converted into "permanent" loans 42 at the close of a construction phase, or refinanced by permanent loans from other sources.

While the concept of a note secured by a traditional mortgage on a residential apartment building is no different whether the collateral pledged as security is held by the borrower in traditional ownership or by a cooperative corporation, the loan un-

41 For instance, a condominium regime is a fee simple estate, while a co-op is a long-term renewable leasehold estate. This makes mortgage financing and title insurance easier for condominiums. See 15A AM. JUR. 2D Condominiums and Cooperative Apartments § 4 (1976) ("[T]he unit owner in a condominium has an interest in real property which descends to his heirs as any other Realty would. . . . On the other hand, the tenant-stockholder in a cooperative association is the owner of shares of stock which pass as personalty to his personal representatives and which may be subject to securities regulation."). See Lawrence J. Fineberg, Common Interest Real Estate—A Primer for the General Practitioner, N.J. LAW., Jan. 1996, at 10. New York co-op boards have significant influence over such matters as the financing of units, the design and alteration of units and the right to determine who may occupy the apartments. See Sterk, supra note 14, at 277. In contrast, condominium associations generally do not have the power to veto prospective purchasers. See id.; see also Phyllis M. Rubenstein & William A. Walsh, Jr., Little House of Horrors: May a Condominium Association Be Held Liable for Failure to Provide Adequate Security or Maintenance in the Common Areas, 22 U. RICH. L. REV. 127, 129 (1988) (stating that condominium associations are potentially liable to unit owners for lack of security or failure to maintain common areas).

42 As noted in note 16, supra, prior to the Great Depression, permanent loans tended to be interest-only loans, five to seven years in duration. In order to eliminate the risk that the developer could not pay off the principal at maturity, pre-Depression era loans were longer term loans (twenty to thirty years) written on an amortizing basis, which would result in the substantial reduction (if not the repayment in full) of the loan at maturity. In the 1970s, however, lenders became quite unhappy holding long-term fixed instruments at rates that may have become most unattractive during a period of high interest. Thus, in order to address the volatility in interest rates, long-term lenders developed a "new" product, which they called the "bullet loan," or the "Canadian roll-over," both of which were three-, five- or seven-year loans written on an interest-only basis. In essence, this "new" product was identical to the pre-Depression loan format that had failed after 1929.
derwriting was somewhat more complicated in the case of the cooperative apartment because the lenders considered the business of real estate and real estate financing to be a "people" business. Lenders were more comfortable making loans to developers whom they knew or to developers who had an established track record. Furthermore, lenders believed (and still believe) that developers would be more likely to have the economic wherewithal to fund the project in the event that the building occupancy did not provide enough capital to operate the building and pay debt service in full. The concept of lending to a cooperative corporation managed by an elected group of homeowners, who likely had no experience in managing an apartment building, was far less attractive, where their ability fund short-falls depended upon the financial ability of a significant percentage of unit owners. The concern over the stability of cooperative owners as borrowers was greatly heightened when, in the 1920s and 1930s, many cooperative corporations became bankrupt. Thereafter, cooperative apartments became quite unpopular not only with lenders but also with prospective unit purchasers as those purchasers became aware that their ability to protect their investment was wholly dependent upon the ability of their fellow shareholders to pay their respective shares of building maintenance costs and debt service.

The financing of cooperative units was complicated by a number of other factors, including the hybrid nature of the security offered to a lender and issues as to whether lenders were authorized to invest in such loan transactions. The individual unit owner possessed two pieces of security to offer to the unit lender, namely: the shares of stock in the cooperative corporation and the proprietary lease. The early lenders believed that they had to have security interests in both properties in order to be truly secure. The problem was that the stock was clearly personal property (governed by the individual State statutes that preceded the Uniform Commercial Code), while the lease could

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43 "It is reported ... that in the 1930s, seventy-five percent of the cooperatives in the Chicago and New York areas failed.... Correspondents, almost without exception, bear evidence to the fact that widespread failure was the story elsewhere as well." Note, Co-operative Apartment Housing, 61 HARV. L. REV. 1407, 1410 & n.25 (1948).

44 The Uniform Commercial Code was not adopted until the 1960s. See Robert S. Summers, Symposium, The General Duty of Good Faith—Its Recognition and Conceptualization, 67 CORNELL L. REV. 810, 813 (1982) ("By the late 1960s, [the U.C.C.]
be treated as either real property or personal property. There were significant issues as to how a lender could foreclose on its security, such as whether the lender was merely acquiring the shares or was foreclosing on the real estate interests created by the lease, or both.

Although today banks are authorized to engage in a wide variety of lending, most often over a wide geographic area, real estate lending in the early part of this century was far more restricted by statute. The ability to make loans to the owners of cooperative units received a boost when amendments to several sections of the National Housing Act granted several federal agencies, including the FHA, the authority to participate in loans secured by cooperative apartments. However, it was not until the 1980s that the making of loans secured by cooperative apartments became uncomplicated.

had been adopted in a majority of states.”). New York, for example, adopted the U.C.C. in 1962. See N.Y. U.C.C. LAW § 1-101 (McKinney 1993).

See, e.g., In re Fort Hamilton Manor, Inc., 149 N.E.2d 856, 858 (N.Y. 1958) (“Under a long line of New York decisions, the interest of a tenant of realty under a real estate lease is not realty but . . . is personal property.”).

See Schaffer v. Eighty-One Hundred Jefferson Ave. E. Corp., 255 N.W. 324, 327 (Mich. 1934) (presenting the argument that stockholders of a cooperative association are not equitable owners in common of the real estate); James L. Winokur, Meaner Lienor Community Associations, 27 WAKE FOREST L. REV. 353, 363-64, n. 44 (1992) (citing Uniform Common Interest Ownership Act, which recognizes the hybrid nature of cooperative ownership); 15A AM. JUR. 2D Foreclosure of Mortgage on Building § 86 (1976) (“Since a tenant-stockholder is not an owner of real estate but merely a lessee who owns stock in his lessor, he is not a necessary party to a suit for foreclosure of the mortgage on the apartment property.”).

The Acts of 1863 and 1864, which provided for the organization of national banks, denied them the power to make loans on the security of real estate. In 1878, the United States Supreme Court expressed as one of the underlying reasons for that denial the intention to keep national banks from embarking on “hazardous real estate speculation.” National Bank v. Matthews, 98 U.S. 621, 626 (1878). The restriction was partially lifted by the Acts of December 22, 1913 (ch. 6, § 24, 38 Stat. 273 (1913)), and September 7, 1916 (ch. 461, § 24, 39 Stat. 754 (1916)), which were incorporated into the National Banking Act as Section 371, which limited national banks to making loans secured by improved and unencumbered real estate located within 100 miles of the bank's place of business. See ch. 191, § 16, 24 Stat. 1232 (1927) (amending § 24 of the Federal Reserve Act). That statute was continually liberalized, so that national banks today have no geographic limitations and have extremely broad lending powers. New York has liberalized its banking laws as well. See N.Y. BANKING LAW § 103(4) (McKinney 1993).


See, e.g., New Jersey's Cooperative Recording Act N.J. STAT. ANN. § 46:8D-2 (West 1989) (explaining that “this cooperative recording act” offers purchasers
Because of the problems generated by cooperative corporation failures in the 1920s and 1930s, the boards of directors of surviving and new cooperative corporations became very concerned about the financial wherewithal of shareholders. These highlighted concerns intensified the practice in which prospective purchasers of cooperative apartment units are required to submit detailed financial statements to the board of the cooperative and required to subject themselves to a significant interviewing process before they will be permitted to purchase shares in the cooperative corporation. In many instances, the process goes far beyond mere economic considerations and focuses on "quality-of-life" issues for the other unit owners in the building. For example, some prospective purchasers have been turned down simply because of their status as celebrities. The rules governing most cooperative apartments permit the co-op board to reject prospective purchasers (although they may not do so on a basis that would be discriminatory under traditional tests).

By contrast, the board of a condominium generally has no right to reject prospective purchasers. If a condo board wants to interdict a proposed sale, its only recourse is to exercise a right of first refusal to purchase the condo unit on the same terms that the unacceptable purchaser was willing to purchase. However, condo boards have begun to follow some of the practices of co-op

"those protections available in transactions for the purchase of real estate,... [including] the equivalent of a mortgage where a cooperative unit is the "asset to be pledged as security for the purchase loans").

"[T]here is no reason why the owners of the co-operative apartment house could not decide for themselves with whom they wish to share their elevators, their common halls and facilities, their stockholders' meetings, their management problems and responsibilities, and their homes." Weisner v. 791 Park Ave. Corp., 160 N.E.2d 720, 724 (N.Y. 1959).

There are many examples of prospective purchasers being turned down simply because of their status as celebrities. Notable examples of these include former president Richard M. Nixon, Ron Perlman, Sol Goldman, and Barbra Streisand. See, e.g., Tony Schwartz, Nixon Drops Purchase of Co-op Following Residents' Complaints, N.Y. TIMES, Aug. 3, 1979, at A1 (discussing the concerns of residents in the cooperative building that "the former President might attract extra attention to the building and result in an invasion of their privacy" as well as pose "security problems"). Co-op boards usually identify concerns for the safety and security of both their current owners as well as the prospective purchaser as the reasons for the rejection (to the extent that the board ever gives a reason for the rejection in the first instance).

See generally Maldonado & Rose, supra note 13, at 1255-56 (describing the power of cooperative boards to "arbitrar[ily] withhold... consent absent a violation of discrimination laws").
boards by demanding that prospective purchasers of condo units submit financial data.\(^{53}\)

As banks became more comfortable with their authority to make loans secured by cooperative apartments, lending conventions became fairly well-defined. Lenders would take a "pledge" of the stock, which would be perfected by possession of that stock by the lender. An assignment of the proprietary lease would be recorded in the land records, and the lenders would obtain a "recognition agreement" from the cooperative corporation. In the "recognition agreement," the corporation would agree that if the borrower (unit "owner") were to default in its obligation to the cooperative corporation, the corporation would give notice to the lender and would provide the lender with the opportunity to cure that default before the cooperative corporation foreclosed upon the unit. Many proprietary leases also provided assurances that if the lender were to "foreclose" on its security, the cooperative corporation would accept the lender as a unit purchaser in the building at the foreclosure.\(^{54}\) However, in most instances, neither the lender nor any other purchaser at the foreclosure sale would have the right to occupy the unit without the approval of the cooperative corporation.

Over time, unit loans on cooperative apartments became relatively commonplace. During the 1960s and 1970s, lenders' default experiences with cooperative apartments did not differ

\[^{53}\] In addition to asking for copies of the contract, condominium boards are now asking for the three most recent federal income tax returns for prospective purchasers, although most boards can be persuaded to accept an accountant's statement of net worth.

\[^{54}\] A typical recognition agreement provision reads as follows:

12. The Lender shall have the right to foreclose or otherwise enforce its lien on the Shares and Lease, or to acquire the Shares and Lease by assignment in lieu of foreclosure, and transfer its interest therein as provided for in the agreements between the Lender and the Shareholder, provided that there shall be no right to occupy the Apartment without any approval of the Corporation required by the Lease. Notwithstanding the foregoing, the Lender shall have the right to have the Lease and the Shares transferred in the books and records of the Corporation and issued in the Lender's name or the name of its designee. If requested by the Lender the Corporation agrees to cooperate with the Lender to obtain possession of the Apartment after default by the Shareholder. Such cooperation will include the termination of the Lease and commencement of appropriate legal proceedings by the Corporation provided that the Lender agrees to pay the reasonable fees and disbursements of the Corporation's counsel.

J. Blumberg, Inc., Standard Form Recognition Agreement Form T394.
THE FINANCING OF CO-OPS AND CONDOS

By the mid-1980s, unit mortgages on both forms of ownership were considered customary and had long since become eligible for sale in the secondary mortgage market.55

III. THE CONVERSION GAME

By the mid-1980s, with the real estate market once again extremely hot, many developers turned their attention to cashing out of residential real estate or cashing in on substantially depressed value residential real estate projects. Several cities, in particular New York, had long ago adopted rent control and rent stabilization laws that severely restricted the amount of money that the owner of residential real estate could charge tenants as rent.56 Properties subject to rent control or rent stabilization had, and still have, significantly depressed values because of these restrictive statutes.57 As a result, the supply of rental property deteriorated both in number and quality of units. The general sense was, and still is, that in those cities with such rent control or rent stabilization statutes, no developer in his or her right mind would construct residential rental property that could be subject to rent restricting statutes.58 In cities with rent control statutes that exempt luxury accommodations from rent restriction, the only new rental apartment constructed were buildings containing only luxury units. Otherwise, developers in

55 Fundamentally, the secondary mortgage market covers all transactions involving the transfer of ownership of a loan after it has been closed by the original lender. “The initial role of the secondary market was to smooth out regional imbalances in the supply and demand for mortgage money. . . . More recently, the secondary market has also increasingly been used to expand housing’s linkage with the capital markets.” CHARLES L. EDSON & BARRY G. JACOBS, SECONDARY MORTGAGE MARKET GUIDE § 1.03[1], at 1-15 (1997).

56 The Emergency Housing Rent Control Law was enacted in 1946 “to prevent exactions of unjust, unreasonable and oppressive rents and rental agreements and to forestall profiteering, speculation and other disruptive practices tending to produce threats to the public health.” N.Y. UNCONSOL. LAW § 8581 (McKinney 1987).

57 “[R]ent control diminishes the value of apartment buildings . . . .” William A. Fischel, Lead Us Not Into Penn Station: Takings, Historic Preservation, and Rent Control, 6 FORDHAM ENVTL. L.J. 749, 752 (1995); see also Calvin R. Massey, Takings and Progressive Rate Taxation, 20 HARv. J.L. & PUB. POLY 85, 92 (1996) (stating “compensation (in the form of rent) is always below the fair market value because that is the whole point of rent control”).

58 See GEORGE STERNLIEB & JAMES W. HUGHES, THE FUTURE OF RENTAL HOUSING 92 (1981) (explaining that during “a time of inflation, owners and lenders simply are not willing to venture into areas in which the absolute rents (as well as the rates of return) will be limited”).
rent-controlled jurisdictions were building only cooperative and condominium residences for sale.

During the same period of time, enterprising real estate players were buying under-valued residential apartment buildings that were subject to rent control and rent stabilization, converting those buildings into cooperatives and condominiums and selling the units, which ultimately would break the rent control or rent stabilization cycle. If a unit in a newly converted cooperative or condominium building was occupied by a rent-controlled or rent-stabilized tenant, the developer endeavored to sell the unit first to the tenant at a special bargain “insider price,” and if that endeavor failed, the developer thereafter would offer the occupied unit to investors subject to the existing occupancy. The investor-purchaser of a tenant-occupied unit made that purchase on what that investor hoped would turn out to be a bargain price, with the further hope that the protected tenant would move (or die), thereby leaving the investor-purchaser free to resell the unit at a much higher price, namely, at a price no longer depressed by rent control or rent stabilization.

The concept of conversion started before the 1980s but really gained momentum in the mid 1980s. See Victoria A. Judson, Defining Property Rights: The Constitutionality of Protecting Tenants From Condominium Conversion, 18 HARV. C.R.-C.L. L. REV. 179, 179 n.1 (1983). The author cites statistics showing that between 1970 and 1976, 106,000 units were converted and between 1976 and 1979, 260,000 rental units were converted. See id. During this period of time, the author of this article represented developers in several conversions and represented both lenders and developers (in separate projects) in individual project financings and in bulk condominium and corporate financings.

In some instances, even the death of the tenant does not terminate the rent control applicable to the unit if a close relative of the decedent continues to occupy the apartment. See N.Y. UNCONSOLID. LAW § 2204.6 (McKinney 1987 & Supp. 1998) (denying heirs a “windfall via decedents” at the expense of the owner's reversion rights, because the regulatory statute's intent was to provide emergency relief for tenants already in occupancy). But see James P. Godman, Note, (E)state of the Law: An Estate's Right to Purchase Its Decedent's Apartment During a Cooperative Conversion, 64 N.Y.U. L. Rev. 1347, 1372 (1989) (“The estate should have the right to buy the apartment at the insider price, as long as the offering plan does not expressly prohibit such sales.”).
In the frenzy to finance the wave of cooperative and condominium construction and conversion, lenders once again began to compete with each other for the opportunity to take security interests in the developers’ units. In this highly competitive market, borrowers were able to insist that the loans be made on a fully exculpated basis, meaning that the lenders’ only recourse in the event of default would be to foreclose on the security, with no right to pursue any of the borrowers’ other assets even in the event of a deficiency.\(^3\) Lenders made bulk-unit loans to developers with respect to which security interests were classified as: (a) developer-unsold shares in cooperatives (in which case the lender took a security interest in the shares of stock and the proprietary lease owned by the developer), (b) developer-unsold condominium units (in which case the developer’s bulk lender took a mortgage or deed of trust on the units) or (c) developer-sold units (in which case, since the only remaining interest that the developer would have after the unit was sold would have been whatever purchase-money security interest that the developer may have retained in either a co-op or a condo, the developer’s bulk-lender took collateral assignments of the purchase-money loan documents and security taken back by the developer from the new unit purchasers). Each category of collateral was further subdivided into additional categories of occupied and unoccupied units, depending upon whether the apartment or unit was occupied by a non-owning tenant. The loans were usually made on the basis of a loan-to-value ratio (i.e., the amount of the loan would be a percentage, usually seventy-five to eighty percent, of the estimated gross sales price of the units). Although these estimated sales prices were frequently tested by appraisal, the values of the appraisals were predicated on then-soaring (and in hindsight, grossly unrealistic) values. Frequently, in order to hype the price of the units, the developers promised to make substantial improvements in the building or to make substantial contributions to reserve funds of the cooperative corporation or

\(^3\) During the 1960s and 1970s, exculpation provisions tended to be plenary. The borrower was simply not liable for anything beyond its interest in the property. By the 1980s, “carve-outs” became more prevalent in exculpation provisions. While the borrower would not be liable generally for any obligations beyond the value of the real estate hypothecated as security for the loan, the borrower would be liable for such matters as fraud (which in reality the borrower may have been liable for even under earlier exculpation provisions), waste, environmental problems, and misuse of insurance proceeds.
the condominium association, or both. In any event, lenders and developers alike were again raking in big profits and the condo and co-op purchasers were delighted with their new acquisitions. Everyone was happy.

IV. THE SECOND DOWNTURN

When the real estate market collapsed again, at the end of the 1980s, lenders found that the value of the cooperative apartment and condominium units with respect to which they held security was worth far less than the aggregate amount of the loan, and because the loan was fully exculpated, they had no recourse against the borrower. Lenders took tremendous losses on these bulk-unit loans.

Those who had purchased cooperative and condominium units in the buildings in many instances were faced with the loss of their own investments. With the decline of the real estate market, cooperative and condominium apartment owners found that the resale values of their units were only a fraction of what they had recently paid for those units and less than the debt that they had incurred in acquiring the units. Those who purchased occupied units found that even if they were lucky enough to have their rent-controlled or rent-stabilized tenant move out, the residual value of the unit was still less than the "discounted" price that they had paid for the unit. But that was nowhere near the worst of the problems. Those who had the misfortune of pur-

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65 See Lisa S. Lim, An Overview of the Effects of Cooperative Sponsor Defaults,
chasing one or more units in cooperative or condominium build-
ing in which the developer still had a significant number of un-
sold units faced additional problems.

As the real estate market declined, the number of sales of co-ops and condos slowed to a crawl. Developers had been de-
pending upon the cash flow from a quick sell-out of their inven-
tory of unsold units to service the debt to the lender who had
provided financing based upon the developer's unsold units and
purchase money mortgages. Because the composition of bulk
loans generally had a small component of developer-held pur-
chase-money mortgages and a large component of unsold units, the
cash flow from the purchase-money mortgages was not suffi-
cient to service the developer's debt. With unit sales inadequate
to generate additional cash flow and to reduce the developer's
debt, the developers were left with a choice of either funding the
shortfall from their own personal wealth to support the debt that
was (with the decline in value of units) now more than the value
of the units, or walking away from the project, knowing that the
developer's debt was fully exculpated from any further liability
to the developer's lender. The choice was obvious.

When the developers walked away from the projects, they
also stopped paying the maintenance charges on the developer-
owned units. Where developers still owned substantial numbers
of units, the impact on the other unit owners was devastating.\footnote{See id. at 355 (detailing the greater financial burdens to the tenant-share-
holders when a sponsor retains a large percentage of units).}
Not only would the condominium or the cooperative corporation
not receive the developers' payments needed for the maintenance
of the building, in the case of the cooperative corporation, the
problem was compounded if the cooperative's building itself was
subject to a large building mortgage.

In most cases, cooperative buildings carried (and still carry)
sizable building mortgages, in addition to the debt secured by the
unit that the unit owner may have incurred. Those building
mortgages may have been there for quite some time, but more
frequently, the developer acquired the building as an underval-
ued rent-controlled or rent-stabilized project by borrowing a high
percentage of the purchase price secured by a mortgage on the
building. The developer then borrowed additional money, also

\footnote{21 REAL EST. L.J. 349, 350 (1993) (reasoning that sponsor defaults leading to fore-
closure will likely wipe out the equity interests of the unit owners).}
secured by a mortgage on the building, the proceeds of which would be used to "spruce up" the building for conversion, to cover the cost of the conversion itself, and the costs of marketing the newly created cooperative units. With no maintenance payments being made by the developer from which debt service could be paid by the corporation, the co-op board generally was unable to service the entire building mortgage debt from increased maintenance to be paid by the remaining unit owners or from a capital call (which usually failed) against those remaining unit owners. As a result, a significant number of building mortgage loans fell into default. Obviously, a foreclosure of the building mortgage would wipe out the equity interests of the unit purchasers and the security in those units that the unit purchasers had given to the banks that had loaned the money to enable the unit purchasers to buy their respective units.

In many instances, the developer also defaulted in obligations set forth in the prospectus or other documents governing the co-op or the condominium, including (a) obligations with respect to deferred maintenance,67 (b) upgrades in the building that were to have been provided by the developer, and (c) contributions of substantial amounts of money that were to have been made by the developer to the cooperative corporation's or the condominium's reserve fund.68

In an effort to protect their investments, unit owners sued the developers only to find that the developers were insulated by business entities that had no meaningful assets beyond the now valueless (to the developer) unsold units.69 There were even instances in which these aggrieved unit owners brought actions against the lenders who had foreclosed the security in the developers' unsold shares or units and taken over those units, claiming that the lender had also taken over the developers' obliga-

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67 Deferred maintenance, as the words imply, refers to matters of building maintenance that have not been addressed in timely fashion. To the extent that a building has experienced some degree of deterioration in building systems or cosmetics, the problems are euphemistically referred to as "deferred maintenance."

68 Most cooperatives and condominiums establish reserve funds to take care of known existing problems for the building, including deferred maintenance. The fund is also necessary as a method of accumulating money over a period of time for identifiable recurring building needs, such as the replacement of the roof and mechanical systems, including air conditioning and heating components.

69 See generally Brown, supra note 64, at 468-69.
tions with respect to the building. Another principal problem for the lenders was, and still is, that public officials are reluctant to countenance foreclosure judgments against the shareholder unit owners of a cooperative apartment building, the net result of which would be to terminate the rights of all of the unit owners. This political atmosphere added to the lender's risk in making cooperative building loans. This atmosphere was at a crisis level in 1991, when it was estimated that there were 500 buildings in New York where sponsor defaults had led to serious delinquencies in the underlying building mortgages. A foreclosure on the building would normally wipe out the ownership interest of the cooperative corporation and all of the proprietary leases, but courts have held that those units that continue to be occupied by non-owner, rent-controlled or rent-stabilized tenants are unaffected by the foreclosure and that the rights of the protected tenants survive the foreclosure. Likewise, those unit owners who were themselves protected tenants prior to the conversion to the cooperative form of ownership are generally held to regain the rights of protected tenants following the foreclosure, although they would have nonetheless suffered the loss of any equity they invested when they purchased their unit. The bottom line for the lenders, however, was that when they did complete a foreclosure on a building, the building was worth far less than the lender had anticipated. The lender had underwritten the loan as one secured by an unregulated cooperative apartment building, and wound up with a building populated in significant part by rent-controlled and rent-stabilized tenants.

Once again, based in part on the bad experiences of lenders with respect to condominium and cooperative loans and on bad experiences with real estate loans of all kinds in general, senior managers at many lending institutions vowed that they would

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70 See 142 East 49th St. Owners Corp. v. BRT Realty Trust, N.Y. L.J., July 9, 1997, at 25 (N.Y. Sup. Ct. 1997) (holding that the successor of unsold shares was obligated to distribute the shares to financially responsible individuals and may be held liable for defaults in payments of maintenance).


73 See De Santis, 578 N.Y.S.2d at 366 (citing N.Y. COMP. CODES R. & REGS. 9, § 2504.1 (1991), stating that protection applies only to occupants who have not defaulted on their rent).

74 See id. at 367 (citing Greenberg v. Colonial Studios, 107 N.Y.S.2d 87, 87 (App. Div. 1951)).
never again become involved in real estate lending.

V. ANOTHER RECOVERY

The early part of the 1990s was a time of depressed values for real estate, and lender reticence about becoming involved in real estate lending continued. It was during this absence of traditional real estate sources of financing that Wall Street took an interest in real estate. More precisely stated, Wall Street took an interest in anything that produced an income stream, on the theory that any income stream could be securitized, and looked to the income streams produced by debt service on mortgages. Taking the concept of the secondary mortgage market to a new plateau, the investment banking houses gobbled up home loans irrespective of whether they were secured by traditional single family homes, condominium units or cooperative apartments. Like Fannie Mae, Ginnie Mae and Freddie Mac, the investment bankers and rating agencies required standardized loan forms, standardized underwriting procedures, sophisticated loan monitoring and a review and rating of the proposed security by a rating agency. These loans were pooled by the investment bankers and placed into the hands of trustees, who would administer the pool. Security interests were sold either in private placements to small groups or to single sophisticated investors, or by public offering to the general public as an investment in an "asset-backed security."

Traditional lenders came streaming back into the market-

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75 See KENNETH G. LORE & CAMERON L. COWAN, MORTGAGE BACKED SECURITIES, DEVELOPMENTS AND TRENDS IN THE SECONDARY MORTGAGE MARKET § 1.03 (1997).

76 Federal National Mortgage Association ("FNMA" or "Fannie Mae") was once a government agency and is now a private, stockholder-owned, taxpaying corporation; Government National Mortgage Association ("GNMA" or "Ginnie Mae") is a government agency (which is part of the U.S. Department of Housing and Urban Development), whose function, among others, is to guarantee principal and interest on FHA and VA mortgages sold in the secondary market; and Federal Home Loan Mortgage Corporation ("FHLMC" or "Freddie Mac") is a government-sponsored secondary market agency, which was originally established to provide a secondary market for savings and loan associations, but which now is authorized to purchase loans from virtually all originators. See EDSON & JACOBS, supra note 55, § 1.03[2], at 1-16 to 1-17.

77 See LORE & COWAN, supra note 75, § 9.01, at 9-1 (stating that "ratings are essential to a strong Mortgage Backed Security because they make the security more readily acceptable and create the enhanced liquidity that is essential to many investors").
place with the understanding that they would now be fulfilling the role of intermediaries. They would make home loans, receive up-front fees and promptly sell the home loans either into the secondary mortgage market or to the investment banking houses for the next securitization. These plays fulfilled the life-long dream of lenders to make significant fee income while laying off 100% of the long-term market risk to the secondary mortgage market, and, ultimately, to the general public.

Loans on whole projects, as well as unit loans and home loans, are available for securitization. While loans to cooperative corporations are not attractive to lenders, in general they have been and continue to be available, although more conservatively underwritten. These too can be securitized. Further, for the first time it is becoming easier for condominium associations to borrow money, because condominiums are now being permitted to grant liens on condominium property. The recent enactment of section 339(jj) in New York is evidence of this trend. This change in law makes the condominium more similar to the cooperative apartment in providing flexibility to the board of directors of the condominium to borrow money for needed improvements to the building or the project. There does not appear to be any reason why such loans could not be sold in the secondary market or securitized, although the rating of both the co-op building loan and the new condo building loan may be at the low end of the rating spectrum, if they can be rated at all.

While the pooling of residential mortgages in the secondary market has become a staple in the lending industry, more recently, Wall Street has been securitizing commercial loans, including loans on hotels, office buildings, industrial buildings and residential buildings. The emergence of this world of securitization initially appeared to ensure the existence of a steady supply of cash to the real estate industry from new creditors. However, the sudden and steep drop in the stock market in the second half of 1998 brought an immediate halt to the seemingly unstoppable securitization trend. For the remainder of 1998 securitized financing was virtually unavailable and several Wall

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79 See LORE & COWAN, supra note 75, at 1-11. The author of this article has represented lenders and borrowers in securitized loan transactions and pooled lending arrangements including securitization involving trophy office buildings.
Street houses took substantial losses on unsold pools of real estate security. The early part of 1999 has not seen much improvement in this sector of financing. Nonetheless, borrowers are still attracted by the lower interest rates offered by securitized lenders despite higher up-front costs and fees when compared to more traditional lending sources. However, the hidden cost to the borrower in a securitized financing comes from a loss of flexibility.

Historically, when times have become difficult in the real estate lending world, lenders and borrowers have endeavored to "work out" problem loans, in some cases quite successfully. Developers had become used to dealing with lenders who were willing to work with them in creating the loan and, if the developer maintained his creditability with the lender, the developer could expect that the lender would be responsive when the developer sought the lender's help when times became tough. In prior times, many of the more sophisticated developers were actually willing to pay slightly more in interest to borrow from a lender with whom that developer had a long-standing good relationship. Banks frequently marketed "relationship" banking to make their loans. With securitization, the game has changed dramatically. Once a loan has been transferred to a trustee, the trustee's actions will be governed by a trust indenture which mandates that a trustee must foreclose upon a property if a loan is delinquent to any material degree for a period of a specified number of days (usually not longer than sixty days). Because of the nature of the trust arrangement, the trustee cannot engage in work-out discussions without a modification or waiver of some of the trust restrictions. This is so notwithstanding the fact that the work-out may well be the course of action that would yield the greatest return to the holders of the securitized interests, and provide some measure of protection and return to the developer.

In that respect, the securitization format is a formulation for disaster to the borrower and unnecessarily increased risk of loss to the investors on the lending side of the transaction. The trust indenture requirement of foreclosure was no doubt added with

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80 See Kenneth Silber, Data Base Marketing: Just How Personal?, U.S. BANKER, Feb. 1998 (stating that banks focus more intently on relationship banking because maintaining close customer contact is difficult in an era of large institutions and mass markets).
the intention of providing the investor with a higher degree of comfort (and therefore security) that delinquencies would be promptly addressed. The problem is that mindlessly requiring the trustee to commence a foreclosure proceeding as the only course of action following a default fails to provide a means that will afford the investor the best result, which might be available only from some other course of action. If the securitization is effected by a sale of all of the securities to a single person or institution, there is hope of salvaging the loan with a workout because that single investor could easily direct the trustee to engage in a workout. The single investor would likely engage in workout negotiations directly with the borrower without significant involvement from the trustee.

On the other hand, if there are multiple owners of the security, it is less likely for a workout to be effected because it would require a modification or waiver of the trust indenture\(^8\) and a willingness of all of the investors to pursue the same workout terms. Frequently, where there are multiple investors in a loan transaction, either as investors in a securitized loan or as participants in a traditional non-securitized loan, the participants are motivated by significantly diverse agendas and are frequently unable to work to a common goal or workout.\(^9\) It must be noted that in securitization transactions, the borrower waives any right to control whether the security is sold to a single or multiple purchasers. The bottom line is that with securitization,

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\(^8\) Typically, a trust indenture will require approval of two-thirds of the beneficial interests in order to permit a waiver or modification of provisions of that trust indenture. See Felicia Smith, Applicability of the Securities Act of 1933 and the Trust Indenture Act of 1939 to Consent Solicitations to Amend Trust Indentures, 35 HOW. L.J. 343, 347 (1992) (stating that any amendment—such as changes in the maturity of principal, interest, impairment of right to sue, or reduction in principal—afflicting the fundamental essence of the security requires majority consent).

\(^9\) There are far too many examples of situations in which a lender made a commercial loan, sold participations in that loan to other lenders and thereafter was faced with difficulties in workout situations. Participants have argued over whether foreclosure should have been commenced, and whether the property acquired in foreclosure should be disposed of and how, to whom, and for how much. Frequently, participants holding a small percentage of the loan would refuse to support any rational plan of action in the hope that they could be such an annoyance to those holding major interests in the loan that the holder of the major interests would simply buy back the interest of the obstinate minority participant, thus guaranteeing a full recovery to that recalcitrant participant. See Daniel B. Bogart, Games Lawyers Play: Waivers of the Automatic Stay in Bankruptcy and the Single Asset Loan Workout, 43 UCLA L. REV. 1117, 1133-94, n.234 (1996) (observing that some lenders gain significant negotiation advantage by remaining obstinate).
the borrower gains some economic advantage with respect to interest costs but loses significant mobility if the market "turns south" or if the borrower is confronted with unanticipated problems.

VI. CONCLUSION (FOR NOW)

We have seen the condominium mature as an ownership form and have watched it advance from a financing curiosity to a fully accepted form to serve as security for a loan. We have also witnessed the acceptance of the condominium by the general public to the point where prospective purchasers would express little preference for conventional fee ownership over the ownership of a condominium. The cooperative form of ownership has fully recovered from the black eye that it received in the early part of this century, to the point that co-ops are very popular among prospective purchasers in those cities in which the cooperative form of ownership is employed. While lenders may still comment that co-op financing is more difficult, co-op financing nonetheless remains readily available.

During the twentieth century and particularly since the advent of the condominium phenomenon in the United States, we have witnessed several cycles of the real estate market. There is a constancy to the pattern. Lenders tread cautiously as the upswing begins. As the upswing matures, lenders are competing to lend into a highly profitable financing boom and the prices of real estate continue to climb to the delight of (a) developers (who are able to earn huge profits while doing real estate deals with less and less of their own money invested in their own projects as the markets heat up); (b) lenders (who are able to earn sizable fees for booking new loans); and (c) homeowners (who are acquiring residential property at prices that they believe will continue to rise). As the cycle hits its apex, prices of real estate have grown to new heights with the expectation of almost everyone that the market will continue to rise for the foreseeable future, all of which is supported by appraisals. In each cycle, the lending community takes comfort in financing techniques that they perceive to be "new" (although they are in reality at most a variation on techniques employed in the past). And at the end of the upswing, the market is invariably undone by the fact that the market had become overvalued. The decline is generally a correction, but one that is so steep that it results in an overcor-
recession. Everyone loses money and vows never to make the same mistakes again. And while some individuals may in fact never again get caught up in another real estate debacle, there will always be enough players to guarantee that the cycles will continue to roll. The land will always be there, someone will always make a lot of money in real estate and others will follow. The magic is in knowing where we are in the cycle at all times.

At the present time in the pre-spring days of 1999, lenders and developers alike are raking in big profits, and condo and co-op purchasers are delighted with their new homes. Everyone is happy.8

However, the mood was shaken for a short period of time. In August 1998, Russia defaulted on its bonds, resulting in a concomitant erosion of confidence in the Asian and Latin American bond markets. Investors turned away from mortgage backed securities to safer U.S. Treasury bonds. The supply of funds from Wall Street for real estate dried up. Property values dropped as much as 25 percent from June 1998 to November 1998. See Laura M. Holson & Charles V. Bagli, Lending Without a Net, N.Y. TIMES, Nov. 1, 1998, § 3, at 1. (noting that the real estate boom fueled by securitization “came to a screeching halt when global turmoil roiled markets in late summer”). Since then, the stock market has rebounded to new-record highs, public confidence in the economy is strong, property values have returned to pre-downturn levels and real estate transactions are occurring at a fast pace, making the downturn in the second-half of 1998 appear (at this time) to have been nothing more than a hiccup in the economy. However, changes have occurred. Securitized lenders are still essentially on the sidelines and REITs which had been extraordinarily aggressive over the past several years are becoming less active in the acquisition of real estate. Nonetheless, money is still readily available for deals from insurance companies, some banks and from offshore investors. Individual purchasers continue to buy residential units at a high volume and at high prices. How long this positive portion of the real estate cycle will continue is anyone’s guess.