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INSTITUTIONAL PURCHASE MONEY FINANCING OF COOPERATIVE APARTMENTS

CHARLES A. GOLDBSTEIN

On July 1, 1971, the New York Banking Law was amended to empower commercial banks, trust companies, savings banks and savings and loan associations to finance purchases of "certificates of stock or other evidence of the ownership of an interest in, and a proprietary lease from, a corporation formed for the purpose of cooperative ownership of real estate . . . ." The new law, developed by the state Banking Department and sponsored by the Governor had, as its avowed purpose, the creation and encouragement of institutional "home mortgage" financing of cooperative apartment purchases.

The Governor's Memorandum, submitted to the Committee on Banks in support of the measure (Assembly 7047), recognized that cooperative ownership of multi-family dwellings had become "an increasingly popular form of 'home ownership' in New York State." Although the advantages of this "attractive housing alternative" were "self-evident," the Memorandum indicated that "special problems of obtaining financing for the purchase of co-ops" had inhibited the full "development" of cooperatively owned housing. The problems were said to result from the fact that "the State's mutual savings institutions, traditionally a leading force in the home financing market, cannot make loans on co-ops," while commercial banks and trust companies, which could make such loans, "often find them unattractive risks because the cooperative stock received as security is usually encumbered by restrictive covenants permitting the cooperative management or tenants to withhold arbitrarily their consent to the sale of stock by the tenant-owner."

Although it is by no means clear that legislation authorizing cooperative apartment loans was required merely to empower savings banks to provide cooperative apartment financing, there is no doubt

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6 Member of New York Bar.
2 Governor's Program Bill No. 81, introduced in the Assembly by Mr. Russo.
3 The Memorandum stated that mutual savings institutions were "unauthorized to make loans secured by stock in cooperative apartments [sic] because technically, the security is not real estate." Id. It is true that savings banks had not ventured into the field of cooperative apartment financing. Savings banks' counsel, however, have advised the author that they did not necessarily agree that savings banks lacked authority to make
that the 1971 legislation was not only useful but crucial to the development of institutional cooperative apartment loan programs.

As the Governor's Memorandum indicated, commercial banks and trust companies had classified cooperative apartment loans "unattractive." The Memorandum pinned this on the fact that cooperative stock is encumbered by covenants restricting the apartment "owner's" right to transfer both his stock and his proprietary lease. Since racial or religious discrimination is believed by many to be the primary cause of unreasonable rejections by cooperatives of proposed apartment transfers, Assembly 7047 contained anti-discrimination provisions designed to protect lenders against the adverse economic effects of prejudice. To this extent, the "risk" was made less "unattractive."

It was not concern over the discriminatory practices pursued by some cooperatives, however, that had kept commercial banks from financing apartment purchases. Rather, the banks' failure to become actively involved in cooperative apartment lending was the result of (1) the fact that the banking industry did not comprehend that "ownership" of a cooperative apartment is as tangible a concept, as a matter of law, as "ownership" of a house; (2) the almost uniform opinion of bankers that secured cooperative apartment loans are, in effect, second mortgage loans on real property having all of the risks associated loans on the security of "cooperative apartments." Counsel referred to section 235(6) of the Banking Law which, long before the 1971 legislation, authorized savings banks to invest in "notes and mortgages on improved . . . real property, including leasehold estates . . ." (emphasis added) as long as the leasehold estates had unexpired terms of not less than 21 years. Almost all cooperative apartment owners are tenants under long-term proprietary leases. Indeed, the "possessor" interest of a tenant-shareholder of a cooperative housing corporation in an apartment is considered the dominant element of the tenant-shareholder's property interest. See Penthouse Properties, Inc. v. 1158 Fifth Avenue, Inc., 256 App. Div. 685, 691-92, 11 N.Y.S.2d 417, 422-23 (1st Dep't 1939); In the Matter of Lacaille [Feldman], 44 Misc. 2d 370, 253 N.Y.S.2d 937 (Sup. Ct. N.Y. County 1964). Consequently, counsel argued, an apartment owner had a mortgageable asset even if his shares in the cooperative were not satisfactory security for a savings bank loan.

4 For a discussion of what a cooperative apartment owner actually owns, see Goldstein, Negotiating for a Cooperative Apartment, 1 REAL ESTATE REV. 75 (1971).

6 The 1971 law added new sections 19-a and 19-b to the Civil Rights Law prohibiting discrimination in the sale (but not subletting) of cooperative apartments on account of race, creed, national origin or sex of a purchaser and creating private enforcement rights.

6 There has been a well established market for cooperative apartments in New York City for at least 50 years. Since combined sale and resale dollar volume amounts to more than one hundred million dollars each year, there would seem to be little reason to believe that either the transfer restrictions inherent in cooperative apartment ownership or actual cooperative transfer practices interferes with, or prevents a significant number of apartment transfers or generally depresses apartment resale values.

7 A Memorandum recently submitted by the New York State Bankers Association in support of a measure to permit five year, high rate personal loan — installment financing of cooperative apartment purchases evidenced this misunderstanding in stating that "[t]he interest in a cooperative is an intangible, not real estate. It is, therefore, not susceptible to conventional mortgage loan financing." N.Y.S. LEG. ANN., 186-87, 1969.
with subordinate financing, (3) the failure of the banking industry to appreciate the tremendous growth in the number of cooperative apartments and to observe the remarkable price stability that had prevailed in the cooperative apartment market since 1946, and, of greatest significance, (4) the general disinclination of commercial banks to increase their portfolio of home mortgage-type loans, of whatever kind or nature, because of their relatively low interest rates and long term maturities. So obvious was the banks' concern over profits that Assembly 7047 included a 1-1/2% per annum interest "bonus" (over the maximum rate otherwise permitted for secured loans—presently 7-1/2%) to motivate banks into making "co-op apartment loans."

Proof that discriminatory practices had not deterred bank lending on cooperative apartments can be found in the fact that, for more than twenty years, commercial banks had been making a great many substantial loans for the purpose of helping special customers purchase cooperative apartments. The loans were made on a credit basis, i.e., short term or demand notes secured by assignments of cooperative stock and proprietary leases. In general, interest rates were keyed to the institutions' prime rates and both the banks and borrowers entered into their loan relationships in the expectation that notes would be "rolled over" time and again at maturity in order to allow ample opportunity for the borrowers to repay their loans. Amortization requirements were "flexible"; the cooperatives whose stock was "pledged" rarely were advised of the loan transactions; and no serious attention was given to the peculiar problem of disposition of the unusual kind of collateral taken for the loans. Although commercial banks never publicized the availability of these loans, the loans were made sufficiently often to business executives, well established self-employed and professional people and other well "connected" customers so that the making of such loans could not be considered unusual.

Moreover, commercial banks, always interested in finding new ways to develop large numbers of short term, high interest rate personal "instalment" loans, many years ago began to make such loans with the knowledge that borrowed funds would be used to finance purchases of cooperative apartments. Because of a desire to obtain the obvious, readily available security for this type of loan (i.e., stock and proprietary lease), to extend the maximum period of repayment beyond the 37 months then allowed for a loan in excess of $1,200, and to eliminate a $5,000 limitation on the amount which a bank might lend, the industry, as recently as 1969, caused section 108-4(b) of the Banking Law to be amended to permit a commercial bank to make a personal loan in any
amount (in excess of $1,200) for as long as 61 months and to take security for the loan in the form of "an assignment or transfer of the benefits of... cooperative ownership," i.e., a collateral assignment of the borrower's stock certificate and proprietary lease.

This "revitalized" and well advertised loan program was aimed at particularly credit worthy applicants having substantial incomes. The banks did not expect that a "popular market" would develop for high interest (12.25-13% per annum), five year self-liquidating loans of the substantial amounts needed to enable most people to purchase apartments. By 1969 apartment prices had reached all-time highs, ranging from $40,000 to $150,000 for six or seven rooms, with most costing $75,000-$100,000 cash.\(^8\) In any event, the banks' aggressive market approach gave no indication of concern over the possibility that the discriminatory practices pursued by some cooperatives would adversely affect their collateral.

Meanwhile, the savings banks, which had not financed the purchase of any cooperative apartments for lack of clear statutory authorization and certain historical reasons, became interested in the "personal loan" approach to cooperative apartment financing. Perceiving that a cooperative apartment loan program might be a significant first step in obtaining much wanted (and long denied) authority to operate personal loan departments, the savings banks began to remind the legislature that they had been the "leading force in the home financing market," and demanded "me too" authority through expansion of Banking Law section 235-8(4)(a), which relates to short term, high rate home improvements loans.\(^9\) The savings bank measure did not succeed

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8 In a Memorandum in support of the measure (Senate 2421) submitted by the New York State Bankers Association, it was stated that the three year, $5,000 limitations on personal loans were "usually sufficient to preclude financing cooperatives..." Id. at 187. Since ordinary interest rates (then fixed at 7-7/4% simple interest, maximum) were "highly unattractive for longer term unsecured instalment loans to individuals," the Association argued, the limitations should be removed. The Association's theory upon which the loans "must be considered unsecured" was that "the interest of a participant in a cooperative is usually so restricted as to sale as to make it valueless."

The interest rate, of course, was the nub of the problem. If the security was "valueless," presumably there was no justification for permitting banks to demand such security. Furthermore, if it was "valueless," the many loans that had been made to special customers which were secured only by security interests in cooperative stock and proprietary leases would be deemed "unsecured"—a notion that surely would be resisted by loan officers faced with queries from bank examiners.

The 1969 amendment may have made this kind of lending attractive to the banks, but it did little to stimulate interest by the banks' customers. It soon became apparent that there was no real demand by anyone for the newly authorized loans. Consequently, no one was heard to protest the repeal of the 1969 amendments by Assembly 7047 in 1971.

9 Assembly 2247, 194th Sess. 1971. The bill would have permitted 61 month loans with five per cent interest per annum, discounted. The loans would be unlimited in
for two reasons. First, by 1971, the failure of the personal loan approach to cooperative apartment financing already had become apparent. The commercial banks were making only a handful of loans, despite the 1969 legislation that they had won. Second, the time had come for re-evaluation of the whole question of institutional financing of cooperative apartment purchases and pressures other than those generated by banks were being brought to bear on the Legislature. Industry and consumer-oriented groups were about to find common cause: the encouragement of institutional financing of cooperative apartment purchases. To explain this phenomenon, it is useful to recount some recent history.

1946-1971

In the fifteen years after the beginning of the Depression in New York, relatively few cooperative apartments were created or transferred. Then, in the quarter of a century following the Second World War, almost all new "cooperatives" in New York City came about through the conversion of luxury rental apartment buildings. "Apartment" prices in the first decade of this period were extremely low (by today's standards). Because it was not uncommon for a 10 room apartment in a first-class building located on Fifth Avenue to be sold for $10,000-$15,000 cash, and because the tenant of such an apartment often had capital reserves which permitted him to make outright payment for the shares allocated to his apartment, the non-availability of bank "financing" for cooperative apartment purchases was hardly noticed. Indeed, to the extent that financing was desired or required, the tenants of these buildings generally were able to obtain bank loans without security or to negotiate bank loans upon other kinds of security, such as marketable securities. In order to promote sales of cooperative apartments in pre-War buildings (which were often resisted by tenants of rent controlled apartments), sponsors of cooperative conversions also offered to finance, for as long as five years, as much as one-half the cash prices of the shares being offered at low "bank rates," i.e., 4-6% simple interest. Consequently, there was no demand for long term, institutional cooperative financing, as such.

By the mid-1960's, however, the cooperative conversion movement, spurred by lingering rent control and increasing landlord-tenant tensions, had spread widely and began to affect apartment houses far distant from the Fifth Avenue-Park Avenue-Sutton Place districts in which most cooperative conversions had taken place since the War. By this

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amount if the proceeds were used to buy cooperative apartments or limited to $5,000 if the proceeds were used for apartment repair and improvements.

10 See note 8 supra.
time, cooperative apartment prices had risen dramatically, so that asking prices for poorly maintained apartments in older buildings on West End Avenue and Riverside Drive (which needed major repairs and modernization) substantially exceeded the sums that had been demanded for Fifth Avenue and Park Avenue apartments only 10 years before. Although sponsor financing became more prevalent (and, by the late 1960's, routine), it was rarely possible for the tenants of these buildings to plan for repayment of short term, self-liquidating sponsor loans out of anticipated earnings alone.

It was not until the late 1960's, therefore, that there appeared to be a substantial demand for institutional cooperative apartment purchase money financing. The demand would be heightened by the inflated prices being obtained on the resale of cooperative apartments. It would be made even more insistent by the general decline in stock market values that occurred at the end of the decade, which caused many people to be unable to make the large, lump-sum cash payments needed for cooperative apartment purchases, and which made others reluctant to tie-up significant portions of their available capital in cooperative apartments.

By this time the cooperative apartment industry also had good reason to want to develop long-term financing programs. Brokers wanted to expand the market for cooperative apartments and to circumvent the effects of economic recession, being well aware of the fact that people could lease city apartments or buy single family houses in the suburbs without investing the large sums of cash needed to buy cooperative apartments.

It was not surprising, therefore, that legislation should be introduced in 1970 and again in 1971 authorizing or encouraging institutional, "home mortgage-type" financing of cooperative apartments. Senate 8564, co-sponsored by 13 State Senators in 1970, would have repealed the amendment made to section 108-4(b) in the preceding year (high rate, short-term loans) and authorized all banks and savings and loan associations to make conventional rate, purchase money loans for periods up to 20 years, not exceeding 75% of the purchase prices of the cooperative apartments (which might be expected, not infrequently, to amount to 90% or more of the apartments' appraised value).\(^\text{11}\) Again, in 1971, Assembly 3305 (multi-sponsored by 16 Assemblymen) would have authorized loans amounting to 80-90% of the appraised value of cooperative apartments.\(^\text{12}\)

\(^\text{11}\) Passed by Senate and then recalled.

\(^\text{12}\) An interesting aspect of this bill was its attempt to define a "cooperative housing corporation," a "participation in a cooperative housing corporation," a "cooperative apart-
The 1971 legislative session saw the enactment of a great many measures designed to encourage the development and improvement of housing in New York City. Considering the vast number of cooperative apartments that had been created, the astounding number of new cooperative apartment offerings that had been made in 1969 and 1970, the generally depressed economic climate and the advent of a sluggish cooperative apartment resale market, the high resale prices of apartments which persisted despite economic recession because of the short supply of superior housing accommodations, and the Governor's desire to make some dramatic advances in the housing field, the enactment of Assembly 7047 into law was predictable. Equally predictable was the fact that, in 1972, the Legislature would find it necessary to correct the new law and that it would undertake to make the law more flexible.

EMERGENCE OF SAVINGS BANK LEADERSHIP

As of May, 1972, only one major New York City commercial bank had announced plans to make cooperative apartment loans in the manner contemplated by the 1971 legislation. The announcement, which was made more than six months after the effective date of the new legislation, constituted the first visible sign of interest by commercial banks in long-term cooperative apartment lending.

Discussions between the author and officers of a few of the other commercial banks which make home mortgage loans (and which, for that reason, are most likely to enter the cooperative apartment lending field), reveal ambivalent attitudes on their part towards commercial bank participation in the purchase money financing program. On the one hand, these banks seem to operate their home mortgage departments primarily for historical reasons, to accommodate the employees of major customers and to justify the advertising of a "full line" of banking services. Home mortgages or cooperative apartment loans are found uninteresting because of low (fixed) interest rates, long maturities, the necessity of maintaining closing and servicing departments and the expense, difficulty and risk incurred in foreclosure. The banks are

14 One bank that does not make home mortgage loans generally available to the public has begun making long term loans to those of its own employees who choose to buy cooperative apartments.
none too happy with their mortgage investments in multiple dwellings located in New York City. Aside from the usual urban problems and risks, there have been the special problems created by successive generations of local rent control laws and an emerging jurisprudence which would subordinate the mortgage lenders' interest in unimpeded rent collections to tenants' interests in building code enforcement. Since the banks are not looking for additional first mortgage investments in urban residential properties, their loan officers argue, they are even less likely to want "second mortgage" loans on cooperative apartments — particularly when they do not hold the first mortgages on the buildings in which the apartments are located. Complicating matters is the absence of lending precedents which might give comfort to bank personnel and their counsel faced, for the first time, with the problems of secured lending on cooperative apartments and the search for practical solutions to these problems.

On the other hand, the banks seem receptive to the notion that they have a moral responsibility to help people who choose to live in New York City rather than the suburbs (which, for many years, have been the prime beneficiaries of the banks' mortgage investments) and to make investments in residential properties in the city in which they conduct their business and obtain their labor force and from which they derive their deposits. If home financing is a part of the banks' lending programs, bank officers will not be unmindful of the higher interest return permitted on cooperative apartment loans. Viewed as a type of personal instalment loan, cooperative apartment loan programs also are attractive — at least for the moment — considering recent reductions in lending rates (prime and instalment) and the large sums available for current lending. Again, conventional, self-liquidating cooperative apartment financing programs would largely eliminate the need for the ad hoc, "informal" financing schemes created for special customers, with all of the difficulties and risks attendant to custom-lending.

These considerations seem sufficiently persuasive to make it reasonable to assume that more commercial banks will be tempted to enter the field and that, eventually, there will be allocated to cooperative apartment financing programs significant portions of the funds that would otherwise be committed to home mortgages or instalment loans.

At present, however, the savings banks and savings and loan institutions have taken the lead in developing long term, purchase money financing programs for cooperative apartments and it would seem that, in the foreseeable future, they will provide the bulk of the funds avail-
able for this purpose. It is for these reasons that the balance of this article will focus on the savings banks' response to the new legislation.\textsuperscript{15}

\textit{Section 235}

Section 235 of the Banking Law enumerates, at considerable length, the only property and securities in which a savings bank may invest.\textsuperscript{16} The 1971 legislation added a new section 8-a, which as amended in 1972, permits such banks to invest in:

Promissory notes representing loans for the purpose of financing the purchase of or refinancing an existing ownership interest in certificates of stock or other evidence of an ownership interest in, and a proprietary lease from, a corporation or partnership formed for the purpose of cooperative ownership of real estate in this state, as provided in this subdivision.\textsuperscript{17}

The amended law provides that any such investment shall not exceed 75\% of the purchase price of the stock and proprietary lease or of the appraised value of the stock and proprietary lease "in the case of a

\textsuperscript{15}Savings banks have far greater impact on lending practices in Manhattan, where most cooperative apartments are located, than savings and loan associations. Although the savings and loan institutions may become an important source of cooperative apartment financing, it is expected that, by and large, they will follow the savings banks' lead insofar as lending practices are concerned.

\textsuperscript{16}§ 235. Investment of funds

A savings bank may invest in the following property and securities and no others:

* * * 8-a. Promissory notes representing loans for the purpose of financing the purchase of or refinancing an existing ownership interest in certificates of stock or other evidence of an ownership interest in, and a proprietary lease from, a corporation or partnership formed for the purpose of cooperative ownership of real estate in this state, as provided in this subdivision.

A savings bank may, subject to such regulations as the banking board finds necessary and proper, invest to an amount not exceeding seventy-five per centum of the purchase price or, in the case of a refinancing, the appraised value of certificates of stock or other evidence of an ownership interest in and a proprietary lease from, a corporation or partnership formed for the purpose of the cooperative ownership of real estate within the state, for the purpose of financing a purchase of or refinancing an existing ownership interest in such a corporation or partnership, provided (a) such investment is secured within ninety days from the making of the loan by an assignment or transfer of the stock or other evidence of an ownership interest of the borrower and a proprietary lease; and (b) repayment of principal and interest shall be effected within twenty years. Notwithstanding any other provision of law, the maximum rate of interest which may be charged, taken or received upon any loan or forbearance made pursuant to this subdivision may exceed the rate of interest prescribed by the banking board in accordance with section fourteen-a by no more than one and one-half per centum per annum. (McKinney Supp. 1972).

\textsuperscript{17}By reason of the 1972 legislation, the loan may be secured by "other evidence of an ownership interest in, and a proprietary lease from, a . . . partnership formed for the purpose of the cooperative ownership of real estate in this state, . . ." There are very few partnership cooperatives in New York. The few that exist probably result from "do-it-yourself" conversions of one or two family houses. The "partnership cooperative" is not as satisfactory as the corporate cooperative and, contrary to the belief of some, the use of a partnership does not avoid the application of section 352-e of the General Business Law. Since the impact of partnership cooperatives is insignificant, no further reference will be made to them in this article.
refinancing” and must be secured “by an assignment or transfer of the stock or other evidence of an ownership interest of the borrower and a proprietary lease.” The 1972 legislation was needed to permit banks to lend money to owners of cooperative apartments who might want to refinance purchase money debt (such as sponsor loans) or to convert portions of their equity investments into debt.\(^{18}\)

Since the maximum amount of a purchase money loan is keyed to the purchase price of the collateral (and not to its appraised value), the loan might equal 90\%, 100\% or 110\% of appraised value depending on the deal that the borrower has negotiated for himself. (The loan would be limited to 90\% of appraised value if it were made to finance the purchase of a single family house or, as noted above, 75\% of appraised value if it were made to refinance a cooperative apartment.) Moreover, there is no statutory dollar limit on the amount of the loan that may be made, so that a savings bank might legally lend two or three times as much on a cooperative apartment as it could on a one-family house ($45,000) if the price of the apartment is great enough.

Section 8-a limits the term of a cooperative apartment loan to 20 years but, thanks to the 1972 legislation, it no longer requires the lender to compel substantially equal, monthly self-liquidating payments (i.e., balloons are now permitted). The maximum rate of

\(^{18}\) Senate 8982, introduced by Mr. Goodman, which resulted in the 1972 changes in the enabling legislation, provided for the “refinancing” of “an existing ownership interest in certificates of stock or other evidence of an ownership interest in, and a proprietary lease from, a corporation or partnership formed for the purpose of cooperative ownership of real estate....” From the Memorandum prepared by the Banking Department in support of the measure, it seems plain that the “refinancing” concept was meant to include not only the refinancing of an existing loan (i.e., a “refinancing” as that term is generally understood) but also an original financing by one who has paid for his shares and proprietary lease (i.e., one who previously elected to make his purchase through “equity financing”). According to the Memorandum, the bill sought to place “existing owners on a par with prospective ‘co-op’ purchasers.” Although the word “refinancing” does not necessarily accomplish this, it is significant that the bill is concerned with a “refinancing” of “an existing ownership interest” rather than “an existing debt.” Thus, a report by the Committee on Housing and Urban Development of the Association of the Bar of the City of New York, which set forth the Committee’s endorsement of the bill, indicated that the measure would make financing “available to those already residing in ‘co-op’ apartments who might desire to borrow against the collateral of their apartments (e.g., to rehabilitate) or to refinance their existing investment which had been made on terms less favorable to them than those authorized last year.” In view of the foregoing, and the simultaneous modification of sections 108-4(b) and 235-(3)(a) to permit “home improvement” loans to owners of cooperative apartments, bank counsel should be satisfied that it was not the Legislature’s intention to limit the new lending authority to those comparatively few instances in which cooperative apartment owners have already borrowed on the security of their shares and proprietary leases and wish to change the terms of their borrowing. An unqualified endorsement of the broad interpretation of the 1972 legislation may be found in the memorandum issued by the Governor when he signed the legislation. Perhaps, also, the Banking Department will see fit to render an opinion to the effect that the 1972 legislation permits banks to lend money to anyone who owns or is about to buy a cooperative apartment.
interest may exceed the annual rate of interest prescribed by the Banking Board (presently 7-1/2%) by as much as 1-1/2% per annum.

If the loan is secured by stock and a proprietary lease, the stock must be that of a "corporation formed for the purpose of the cooperative ownership of real estate within the state" (italics added) and not any other state. (New York City savings banks may make home mortgages in other states.) Although there is no restriction on the type of corporation (e.g., business or not-for-profit), it is not clear whether the corporation must have a single purpose only or whether it is sufficient that the primary purpose of the corporation be the cooperative ownership of real estate.19

19 There is no general, statutory definition of a "corporation . . . formed for the purpose of cooperative ownership of real estate." Relevant statutory definitions are as follows:

[Cooperative Apartment Corporation] For the purposes of this paragraph the term "cooperative apartment corporation" means a corporation (a) having one and only one class of stock outstanding, (b) all of the stockholders of which are entitled, solely by reason of their ownership of stock in the corporation, to occupy for dwelling purposes apartments in a building owned or leased by such corporation, and who are not entitled either conditionally or unconditionally, except upon a complete or partial liquidation of the corporation, to receive any distribution not out of earnings and profits of the corporation, and (c) eighty per cent or more of the gross income of which for the taxable year in which the taxes and interest described in this paragraph are paid or incurred is derived from tenant-stockholders, and the term "tenant-stockholder" means an individual who is a stockholder in a cooperative apartment corporation, and whose stock is fully paid-up in an amount not less than an amount shown to the satisfaction of the tax commission as bearing a reasonable relationship to the portion of the value of the corporation's equity in the building and the land on which it is situated which is attributable to the apartment which such individual is entitled to occupy.


[Cooperative Housing Corporation] (1) Cooperative Housing Corporation—The term "cooperative housing corporation" means a corporation—

(A) having one and only one class of stock outstanding,

(B) each of the stockholders of which is entitled, solely by reason of his ownership of stock in the corporation, to occupy for dwelling purposes a house, or an apartment in a building, owned or leased by such corporation,

(C) no stockholder of which is entitled (either conditionally or unconditionally) to receive any distribution not out of earnings and profits of the corporation except on a complete or partial liquidation of the corporation, and

(D) 80 percent or more of the gross income of which for the taxable year in which the taxes and interest described in subsection (a) are paid or incurred is derived from tenant-stockholders.

(2) Tenant-Stockholder—The term "tenant-stockholder" means an individual who is a stockholder in a cooperative housing corporation, and whose stock is fully paid-up in an amount not less than an amount shown to the satisfaction of the Secretary or his delegate as bearing a reasonable relationship to the portion of the value of the corporation's equity in the houses or apartment building and the land on which situated which is attributable to the house or apartment which such individual is entitled to occupy.

(3) The term "tenant-stockholder's proportionate share" means that proportion which the stock of the cooperative housing corporation owned by the tenant-stockholder is of the total outstanding stock of the corporation (including any stock held by the corporation).

(4) Stock Owned by Governmental Units—For purposes of this subsection, in determining whether a corporation is a cooperative housing corporation, stock owned and apartments leased by the United States or any of its possessions, a
There is no description of the security interest that must be obtained in the borrower's interest in the cooperative apartment, i.e., whether it must be a pledge of, or mortgage on, the proprietary lease as well as a possessory or other lien in the stock. It is only required that the investment be "secured . . . by an assignment or transfer of the stock or other evidence of ownership interest of the borrower and a proprietary lease." (Compare the specific mortgage requirements of section 235(6) which pertains to financing of one-family houses.) There is no overall limitation on the number, or aggregate dollar amount, of cooperative apartment loans that may be made by a savings bank.

The Banking Board, which is given the power to promulgate such regulations in respect of the loans as it may find "necessary and proper," has issued no regulations and has not made public any intention to do so. This leaves savings banks to their own devices in determining overall loan policy and specific loan criteria; it also leaves to savings bank counsel the necessity of determining not only what kind of documentation is needed to satisfy the requirements of section 235 but also how to fully protect their clients' interests.

Overall loan policy is not difficult to formulate. The following is a list of the matters which are being considered by the savings banks in this regard.

1. **Percentage of Purchase Price or Appraised Value:** Despite early indications of conservative attitudes, most savings banks (and the single commercial bank making cooperative apartment loans) are prepared to make purchase money loans ranging from approximately 55% to 75% of the price paid for cooperative shares. In other words, they require their borrowers to invest 25% to 45% of the cash needed to effect purchases. Within this lending range determinations are being made on the basis of credit considerations, including the amount and term of the loan, as well as the appraised value of the collateral. Greater percentages are being allowed in connection with new cooperative offerings (particularly conversions) rather than in connection with "resales" because the offering prices are more often "below market." Because the 1972 legislation became effective in May, there is not yet any lending experience with respect to "refinancings." Presumably

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State or any political subdivision thereof, or any agency or instrumentality of the foregoing empowered to acquire shares in a cooperative housing corporation for the purpose of providing housing facilities, shall not be taken into account. 

INT. REV. CODE of 1954, § 216(b).

See also N.Y. REAL PROP. LAW § 236 (McKinney 1968), which refers to a proprietary lease as a lease held by a tenant "entitled thereto by reason of ownership of stock in a corporate owner of premises which operates the same on a cooperative basis."
there will be no material difference in lending policies already followed.

2. **Interest Rate:** Although savings banks uniformly require a 7-1/2% interest return on home mortgages (the maximum presently permitted), they (and their commercial bank competitor) have established a 9% interest rate (the maximum presently permitted) on cooperative apartment loans. Because the savings banks insist that an assignment of a cooperative apartment is not as satisfactory as a home mortgage, and because the banks are facing “start-up” expense in developing this new kind of loan, they assert that they are justified in charging at least 20% higher interest than they charge on mortgage loans. It is likely that the alleged “inferiority” of the collateral will be used to justify an even greater spread between the two types of “home loans” if and when the general mortgage interest rate drops below 7-1/2% per annum, as evidenced by the fact that the commercial bank making cooperative apartment loans presently charges only 7% on its mortgage loans (28.5% spread).

3. **Maturity:** The principal real estate brokerage firms in New York City that market “first offer” cooperative apartments insist that the 20 year maximum maturity permitted by the statute is the minimum acceptable maturity needed to make self-liquidating bank loans attractive to would-be purchasers of cooperative apartments. Assuming a 9% interest rate, a 20 year maturity results in a constant, aggregate annual payment equal to 10.8% of the original amount of the loan. Nevertheless, the sole commercial bank making cooperative apartment loans has been reluctant to lend for longer than 15 years; and while a few savings banks are willing to make 20 year loans, most limit them to 10, 12 or 15 years. Because the shorter maturities result in “constants” as great as 14%, cooperative apartment financing is not nearly as favorable to the borrower as home mortgage finance. While a 12 year

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20 Although not required, a savings bank is likely to require a security interest (chattel mortgage) in personal property used in connection with the apartment, such as ranges, refrigerators, air-conditioning equipment, etc., where the same is owned by the borrower, because the removal of such equipment would adversely affect the value of the collateral. Compare section 103 of the Banking Law, however, which provides that a cooperative apartment loan made by a commercial bank must be “unsecured except to the extent of an assignment or transfer of the stock certificates or other evidence of ownership interest of the borrower and the proprietary lease.” This language, derived from substantially identical language formerly contained in 108-4(b) of the Banking Law relating to instalment loans, would seem not only to preclude a chattel mortgage in appliances but also the acceptance of a collateral guarantee or other security for a loan. Although it may be argued that the higher interest rate permitted on cooperative apartment loans is not justified if the bank obtains collateral in addition to the stock and proprietary lease, since no such prohibition against extra collateral is contained in the provisions of the Banking Law relating to thrift institutions, it appears likely that the restrictive language was not intended and that it should be repealed.
loan may be better than nothing, or may be acceptable if the amount borrowed is relatively small, it is considerably less attractive than home financing terms which, assuming the 7-½% maximum allowable interest rate and the customary 25 year term, permit a somewhat lower than 9% constant. Since few borrowers are expected to live in their apartments for more than 10-15 years and the banks may provide for acceleration of loan maturities on the sale of the apartments, it may be that the shorter term loan concept is being used to limit the number of loans which savings banks may be called upon to make. In response to such criticism, the banks assert that the loan term should relate to life expectancy (which excludes, for the most part, borrowers over 65) and anticipated duration of earning capacity without regard to the amount that may be realized upon sale of the collateral, because (they insist) the collateral is not too satisfactory. They also point out the overall trend is to make shorter term loans as a protection against interest rate fluctuations in times of "tight money." Whether the savings banks are willing to make the shorter term loans with amortization schedules based on 20-25 payouts (i.e., "balloon loans") under the authority granted by the 1972 legislation remains to be seen. The sole commercial bank making cooperative apartment loans has, to date, not permitted balloons although it had the power to do so from the start.

4. Financial Responsibility of the Borrower: As previously noted, savings banks are prone to view cooperative apartment loans as being "unsecured," justified only if the borrower's credit is very good — which means better than it must be for a loan made on the security of a first mortgage on a single family residence. One reason for this attitude is the persistence of the mistaken notion that ownership of a cooperative apartment is a less tangible form of property ownership than ownership of a house. Another is the belief that restrictions on transfer and possible loss of the collateral to a foreclosing mortgagee (on the building in which the cooperative apartment is located) seriously reduce the value of the collateral. The relative unfamiliarity of savings bank personnel with the cooperative apartment market also tends to eliminate the apartment from focus. (Heretofore, none of the savings banks' borrowers lived in cooperative apartments, so that bank personnel have never been called upon to appraise cooperative apartments or consider their value as security.) Another reason for the banks' unwillingness to rely upon the value of the collateral is that the Banking Department, in an effort to prod savings banks into making loans, has urged them not to view such loans as "real estate" secured loans which, necessarily, are encumbered with time consuming, expensive loan procedures (e.g., title insurance, non-disturbance agreements, mortgage recording taxes,
etc.) In any event, to the extent that the credit requirements for cooperative apartment loans are more restrictive than those applied to home mortgage loans, they will have the effect of limiting the market and discouraging loan applications. Thus, it was reported in the New York Times that the president of one savings bank said that his bank would not make a cooperative apartment loan unless the borrower's monthly income is five times the cost of carrying the cooperative apartment each month, including debt service on the loan. Despite extensive advertising of the bank's loan program and a declared willingness to make loans, it appears that the bank has been closing only a few loans each month.

5. **Appraised Value of Apartment:** Although the law does not require an appraisal in case of a purchase money loan, a savings bank may wish to make one. In times of housing shortages, purchase prices (the basis upon which loan amounts are determined under the statute) often seem to have no direct relationship to "true value," considered in terms of replacement costs, economic life, a tenant-shareholder's equity in the cooperative corporation and its property, prices obtained on comparable apartment sales over a period of five years, etc. If an appraisal is to be made, as it must be in the case of a "refinancing," who should make it? Presumably none of the staff appraisers presently employed or used by savings banks has the expertise needed to appraise cooperative apartments. Such expertise requires, among other things, access to apartment sale records; these are maintained privately and "comparables" cannot be discovered from public records. If outside appraisers are to be employed, will the borrowers be expected to pay the full cost, which may be several times the amount of the "appraisal fees" charged on home mortgage applications? It is believed that the Banking Department has urged banks not to adopt appraisal procedures that will delay consideration of loan applications and make closings more costly.

6. **Location of Properties:** How many loans should a bank make in the same apartment building? same neighborhood? same city? Although savings banks have been known to finance virtually all homes built in a single tract, thereby acquiring the greatest interest in the continued vitality of the community and the quality of the buildings, cooperative apartment lending involves different considerations which may make "saturation lending" inappropriate. First, there are apartment houses with as many as six hundred or more apartments; there are housing developments, with many buildings operated together, containing more than ten thousand apartments. Under these circumstances, the risk of casualty or condemnation loss, neighborhood decay or loss of the
building(s) through foreclosure (resulting from a failure, most likely in a depression, of an overwhelming number of tenant-shareholders to pay their respective shares of mortgage debt service or real estate taxes) is, arguably, considerably greater than the risk of collapse of an entire suburban community. Second, most cooperatives own buildings that will be 20-50 years old when savings banks are called upon to make their first cooperative apartment loans. The banks, therefore, must consider the economic life of the building, the cost of preserving that life and the ability and willingness of all of the tenant-shareholders (not only its borrower) to pay that cost in determining the number of loans they should make in each building or project.

7. Maximum Dollar Limitations: New York savings banks may lend as much as $45,000 on the security of a mortgage on a single family residence. Some banks do; many fix limits which are $5,000-$10,000 less than the legal maximum. It would be understandable if savings banks were to place similar restrictions on cooperative apartment loans. Because cooperative apartments tend to be more expensive than homes, however, such limitations also will limit the value of the loans to prospective apartment purchasers. Presumably, it is in recognition of this fact that the commercial bank which is competing for cooperative apartment loans, and which presently limits a home mortgage loan to $60,000, is prepared to lend $100,000 on an apartment.

8. Mortgagee Protection: It is possible, although unlikely (except, perhaps, in a depression), that while the borrower may continue to pay debt service on his cooperative apartment loan, the cooperative which owns the building in which his apartment is located will be unable to meet the debt service requirements on its own mortgage because of widespread failures of tenant-shareholders to pay maintenance charges. If this occurs, the holder of the mortgage on the building may foreclose and terminate all proprietary leases, thereby causing the evaporation of a savings bank's security for its apartment loan. While it may be provided that termination of a proprietary lease will cause acceleration of a purchase money loan, it is of little comfort to a bank that, at the very time it needs its security the most (such as in a depression), it may be deprived of it. The problem does not exist if the savings bank also holds the mortgage on the building. In such a case, presumably the bank, in making an apartment loan, is lending against some reasonable percentage of an allocable share of the fair market value of the building over and above the lien of its mortgage. On the other hand, if a savings bank does not hold the mortgage on the building, it may be less inclined to make a huge investment in loans on many apartments in that build-
ing. In new offerings where the bank does not hold the mortgage on the building, it may be possible to make arrangements with the mortgagee to obtain some type of formal, non-disturbance protection against the risk of a default on the mortgage. For instance, if the savings bank should hold a large cooperative apartment loan portfolio at the time of default, it may wish to have a contractual right to acquire the first mortgage; or, it may prefer a moratorium on amortization payments and/or a reduction in the interest rate payable on the mortgage which it, as the holder of a secured interest in many apartments, will be called upon to pay in order to prevent foreclosure; or, it may want an outright non-disturbance agreement in which the mortgagee agrees that, in all events, the cooperative operation of the property will continue, that tenant-shareholders will not be required to pay increased rent (maintenance charges) in order to cover mortgage debt service and that such debt service, to the extent unpaid, will either abate or remain a charge on defaulting tenants' shares only. As of this date, agreements of this sort have not yet been made but, theoretically at least, there is great potential for developing savings bank protection in new offerings. The importance of this lies in the fact that, if the "foreclosure fear" can be eliminated, savings banks should be more responsive to arguments that they should engage in large scale cooperative apartment loan programs. In such event, an assignment of a cooperative apartment becomes "as good as" a home mortgage.

9. Commitment Periods: There is no important difference between the commitment period needed by a purchaser of a cooperative apartment and that needed by a purchaser of a house if the building in which the apartment is located is a cooperative at the time of the loan application or if the apartment is being purchased from a tenant-shareholder. When an apartment is being purchased under a plan to build a cooperative or to convert an existing rental property into a cooperative, however, most often it is not known at the time the purchase is made just when the closing under the cooperative plan will take place. In fact, it is not unlikely that the closing may take place from one to two years thereafter. Savings banks have traditionally limited the duration of their mortgage commitments to about 90 days. In the case of cooperative plans, however, they have already begun to extend the period to 12-18 months. Obviously, flexibility is required. The fact that the loans are being made at substantially higher interest rates than those paid on home mortgages should make it easier for savings banks to agree to long term commitments.

10. Cooperation by the Cooperative: The validity and effective-
ness of the savings bank's security interest in a cooperative apartment and the bank's ability to transfer its collateral in the event of foreclosure (and its right to sublease the apartment until the collateral can be disposed of at a fair price) are subject to the terms of the cooperative's by-laws and proprietary lease. Since tenant-shareholders, to a considerable degree, depend upon the financial responsibility of their neighbors, their neighbors' willingness to support a program of maintenance and improvement consistent with shared notions of financial responsibility and taste, as well as their neighbors' willingness to "cooperate" in abiding by house rules, etc., limitations on the right to transfer or sublease apartments are thought to be fundamental to the cooperative scheme, and cooperatives jealously guard their prerogatives in this regard. Under existing case law, it would appear that the boards of directors of cooperative housing corporations have an almost arbitrary right to withhold consent to transfers\textsuperscript{21} as well as sublettings. This has led many a lender to wonder what would happen if, after the borrower defaults, a board of directors flatly refused to permit a transfer of an apartment to almost anyone. Although it is obviously in the interest of the directors of most cooperatives to encourage lending on the security of cooperative apartments (because the directors are, themselves, tenant-shareholders and the availability of financing almost certainly increases not only the prices at which apartments may be sold but also the stability of the market for such apartments), it is possible to think of circumstances in which a board of directors might test, to the limit, its power to obstruct a resale of an apartment. For this reason, savings banks are reluctant to place themselves "in the hands" of such volunteer boards of directors and would prefer to have no restraints on their right to transfer apartments involuntarily "acquired" or, at most, to have their right to cause such transfers depend solely upon consent of a professional management firm (which is unlikely to become involved in improper or irrational anti-bank schemes). The fear of irrational behavior, sometimes voiced by lending officers, is not new. Sponsors of cooperative offerings have frequently reserved special rights to resell so-called "unsold apartments" which they acquire at the closing of cooperative plans that take place when less than all of the shares have been sold. It is worthy of mention that there have been very few instances in which a sponsor's power to sell unsold apartments without the cooperative's approval has been abused. By and large, also, the ultimate "mix" of tenant-shareholders, chosen in the uncontrolled discretion of the sponsor or with the manag-

ing agent's consent, turns out no worse than it would have been if all of the apartments had been sold to the people who, rather fortuitously, happened to be living in the building at the time of conversion. The issue is, nevertheless, an emotional one for cooperatives and savings bank insistence upon special transfer rights (which, in virtually all instances of existing cooperatives, cannot be granted without the consent of an absolute majority or more of the tenant-shareholders) will create substantial obstacles to the establishment of this type of financing except in new offerings in which provision is made for such rights at the very outset. It may be assumed that if the savings banks are prepared to accept some reasonable restraints on their right to dispose of their collateral, most cooperatives will accommodate their desire for special treatment. It may also be assumed that in the most "exclusive" cooperatives no such accommodation will be forthcoming. While a refusal to accord any special rights leaves it to the banks to decide whether or not they are willing to make loans to tenant-shareholders of such "uncooperative" buildings, the problem is not too great since the most "exclusive" cooperatives tend to have the most expensive apartments and the market for 9% loans of $100,000 or less is probably not very great among people who are called upon to pay $250,000 to $500,000 for their shares.

11. The Cooperative's Financial Condition: If the apartment is appraised, presumably the appraiser will consider not only the value of the tenant-shareholder's equity in the cooperative (in terms of the liquidation value of its assets) but also the willingness and ability of the cooperative to properly maintain and operate its property. While the borrower may be financially secure his neighbors may not be, with the result that the cooperative's board of directors may not be willing to fix maintenance charges or to make extra assessments needed for first-class maintenance or necessary improvements. Just how this factor is to be weighed into the appraisal is not too clear. In any event, even if no appraisal is made, a savings bank must consider what standards it will have for the cooperative's financial condition as well as its borrowers' financial responsibility. What kind of working capital does the cooperative have? How sound is its mortgage financing? Are there rent collection problems? Are real estate taxes too high? Does the bank want to make a loan to someone who wants to purchase an extraordinary penthouse perched atop a deteriorating building? Other considerations include the cooperative's record of management responsibility, the competence of its managing agent, the economic circumstances of its tenant-shareholders, and in general, the cooperative's ability to manage its affairs without passing from one financial or legal crisis to another.
12. *Apartment Improvements*: Does the apartment need repair or modernization in order to establish or preserve its value? If so, the savings bank may decide to require its borrower to invest in “home improvements” as a condition to obtaining a loan. The investment may be financed by allowing a larger percentage of the purchase price or appraised value (up to the 75% maximum) or by making a separate “home improvement loan.” The 1972 legislation amended section 235-(4)(a) to expressly permit loans not in excess of $5,000 for periods not longer than 61 months for the purpose of financing alterations, repairs and improvements by lessees under proprietary leases. The maximum interest rate on such loans is 6% per annum, discounted, if the loan maturity does not exceed 37 months or 5% per annum, discounted, if the loan maturity exceeds 37 months. Home improvement loans must be repaid in equal or substantially equal monthly installments. (Like amendments were made to the home improvement loan provisions affecting commercial banks (section 1084(b) of the Banking Law) and savings and loan associations (section 380(2)(b) of the Banking Law).)

Savings banks have many years’ experience in making home mortgages and rely upon an abundance of statutory and pragmatic guidelines for such lending. The Legislature and the Banking Department are prepared to allow, in the first instance, each savings bank to formulate criteria for its cooperative apartment loans. While this permits healthy experimentation and encourages entry into the field, savings banks are left with an unaccustomed burden. There may be some danger that the burden will be avoided by the simple expedient of “going slow.”

**Documentation**

If the Banking Law gives little guidance in respect of loan criteria, it gives even less guidance in respect of required loan documentation.

The new law definitely requires a promissory note. Since the authority to make cooperative apartment loans is not contained in section 235(6) (which covers, in general, notes and mortgages on real property—including leasehold estates), the provisions of paragraph (f) of subdivision 6, which permit waiver of the bank’s right to obtain a deficiency judgment, would not seem to apply. This is consistent with home mortgage lending practices although, it should be mentioned, sponsor financing of new cooperative apartment offerings has, for the most part, been made on a non-recourse basis.

As originally enacted section 8-a required an “assignment or trans-
fer of the benefits of cooperative ownership” in order to secure a loan. Since the “benefits” of cooperative ownership are derived from one’s ownership of shares of the cooperative corporation (or from a membership in such corporation if it issues no shares) and a leasehold estate created by a proprietary lease (or an occupancy license created by an occupancy agreement), it was generally assumed that “an assignment or transfer of the benefits of cooperative ownership” ordinarily involved an assignment of the stock certificate and proprietary lease. The assignment of the stock certificate would create a security interest in the shares evidenced by the certificate, i.e., a “pledge.” The assignment of the proprietary lease also would create a security interest or a mortgage lien on the leasehold estate created by the lease. The 1972 legislation confirmed the general assumption eliminating the “benefits” language and providing expressly for an assignment of a stock certificate and proprietary lease.

The basic documentation for an apartment loan, therefore, would seem to be a promissory note, a security agreement and/or a leasehold mortgage supported by a stock power and assignment of lease. This conclusion does not mean that the documentation will be uniform. For instance, some banks are using negotiable promissory notes; others are not. Several banks use a “loan-security agreement” purporting to create a “continuing security interest” in both the shares and proprietary lease; at least one bank uses a “loan-security agreement” which creates a “security interest-mortgage lien” in the shares and proprietary lease; still another bank uses a “security agreement” creating a “security interest in the shares, the proprietary lease and distributions made by the cooperative,” as well as an “indenture” creating a mortgage lien in the leasehold estate created by the lease and a security interest in the nature of a chattel mortgage on all articles of personal property used in connection with the apartment covered by the lease.

Supporting documents used by the various savings banks also are not uniform. All banks appear to be using commitment letters which are issued upon approved loan applications. Similarly, all banks recognize the need for delivering disclosure statements meeting the requirements of the Federal Truth-in-Lending Act at the time the commitment binds the borrower (and before the loan is made). All savings banks are requiring agreements from the cooperatives involved which provide for some or all of the protections usually insisted upon by leasehold mortgagees. Some banks, however, are requiring title insurance while others are requiring affidavits of title and/or official record searches for security interests and liens. Again, while all banks require instruments of assignment, executed “in blank” to facilitate transfer of the shares
and lease upon default, one bank also requires written consent to service of process in the jurisdiction. Several banks require or "strongly suggest" term life insurance—which may be purchased through them. (The commercial bank making cooperative apartment loans allows, but does not require, its borrowers to obtain up to $15,000 credit life insurance under a group plan.) At least one bank will obtain a "purchase statement" to assure compliance with Regulation U of the Federal Reserve Board when it engages in a refinancing of an ownership interest. Some of the banks use lengthy documents; the loan papers used by others are notably concise and simplified.

The substance of, and principal differences in, the documentation merit examination.

**Loan Application**

The first savings bank to advertise the availability of cooperative apartment loans (October 1971) used an application which was substantially identical to a home mortgage loan application. Indeed, it could not be determined from the first page of the two-page application, which has a great many items requiring completion by the applicant, that it applies to cooperative apartment loans except for the title "Cooperative Apartment Loan Application." Moreover, only one-quarter of the space on page two of the application pertains to the cooperative apartment being purchased. It calls for identification of the cooperative and the apartment, as well as a description of the apartment. The only information requested with respect to the proprietary lease is its date. The only other reference to the cooperative apartment is the following inscription: "(NOTE: COPY OF PROSPECTUS AND PROPRIETARY LEASE MUST ACCOMPANY THIS APPLICATION.)"

The "prospectus" would seem to refer to the offering statement which must be used in the case of "first offer" cooperatives in New York State. Since offering statements are never printed in large supply, are rarely available years after a closing under a cooperative plan, and soon become "outdated," it is assumed that the bank does not require a copy of the statement when it is financing a resale of an apartment.

The application is accompanied by a form letter which warns a prospective applicant that he must "make sure that [his] stock in the corporation can be assigned as collateral" because "the law does not permit [the bank] to make a loan unless this condition can be met." The warning is surprising because, in the author's experience, collateral assignments of cooperative stock and proprietary leases are almost never prohibited. Cooperatives formed prior to 1950 often use a proprietary lease which makes it a default for the tenant to pledge his shares with-
out the consent of the board of directors; but this is a question of consent only, and presumably consent may be obtained, if requested. If, as is the case, the savings bank demands that the cooperative enter into an agreement with it affording the bank certain "lender's protections," surely it can obtain any necessary consent at the same time. Indeed, such consent is likely to be easier to obtain than the other protections that the bank may require—and which are not described in the letter. In any event, there would seem to be no reason to discourage applications from purchasers of apartments in cooperatives requiring consent; and in virtually all cooperatives formed since 1959, the mere pledge of the shares is permitted without consent of any kind.  

The savings bank that prepared the application deserves to be commended for its eagerness to enter into a new field of lending. Its loan application procedures, however, appear inadequate. As it develops its lending program it will discover that a loan application should require, in addition to financial information on the applicant himself, information as to:

1. the intended use and occupancy of the apartment (so that bank counsel may determine that it is permitted by the proprietary lease);
2. the anticipated financial obligations of the applicant to the cooperative (in addition to the monthly rent (maintenance charges), there may be more or less regular special assessments for operating deficiencies, electricity, gratuities, building improvements or decorations, etc.);
3. the financial condition of the cooperative itself, including certified financial statements for at least three years (in order for the bank to determine the likelihood of substantial rent increases or other assessments in the foreseeable future, the existence of any pending lawsuits or audits and the ability of the cooperative to refinance mortgage indebtedness);
4. the organization of the cooperative, including copies of the certificate of incorporation and by-laws of the cooperative as well as a copy of its proprietary lease (in order to examine restrictions on transfer of shares and leases, to verify the existence of an "escape clause" and to consider what protections the bank needs against an exercise of the "escape" right by its borrower, and to determine if the cooperative has been organized in a manner that complies with the requirements of section 216 of the Internal Revenue Code which allows tenant-shareholders income tax deductions, absent which the value of the tenant's interest in the cooperative is likely to be adversely affected);

22 Anyone requesting a loan application automatically receives, in addition, papers needed to open a savings account and an application for depositor's life insurance. Presumably the savings bank requires both.
5. the purchase contract, including conditions contained in the
document relating to payment and financing of the purchase price, the
name of the seller and his attorney (whose help may be indispensible
in obtaining approval of the financing transaction by the cooperative
and an agreement from the cooperative affording special protections
to the bank), the name of the applicant's attorney and a description of
any property affixed to the apartment (kitchen appliances, hardware,
lighting fixtures, etc.) which the seller intends to remove from the
apartment; and

6. the borrower's place of business (if located in only one county
in New York, a Uniform Commercial Code filing should be made there
as well as in the county in which the apartment is located, the county
in which the borrower resides when the loan is made and in the Albany
office of the Department of State). \(^2\)

Examination of loan applications used by savings banks other than
the one mentioned above indicate similar inadequacy. None call for
any of the essential data described above. Required information on the
cooperative and the apartment itself varies from one bank—which re-
quires such data as a diagram of the apartment, the number of apart-
ments in the building and the total number of shares outstanding, to
another which inquires as to the cost per share, the value of furniture
included in the purchase price, the age of the building, the propor-
tionate share of building mortgage indebtedness attributable to the
apartment and whether there is a doorman. Some questions are confus-
ing ("Executive Cooperative Date"—which may mean "effective con-
version date under a cooperative plan"; "Year Bought"—what and by
whom?; "Sponsor Corporation"—most sponsors are not corporations).
Perhaps of most importance, unlike the application used by the first
commercial bank to make this kind of loan, all of the savings banks' 
forms fail to distinguish clearly between a transaction involving a pur-
chase of an apartment pursuant to a cooperative plan and one involving
a resale. By reason of the 1972 legislation, also, the application should
contemplate the possibility of a "refinancing."

Loan Commitment

The loan commitment letters being issued by savings banks follow,
fairly closely, the form of the commitment letters that the banks use
for home mortgages.

All specify the essential terms of the proposed loans (amount, in-
terest rate, maturity, payment terms, prepayment rights), and all state
that the commitments expire on specified dates unless extended by the

\[^2\] See "Ancillary Documents and Procedures" infra p. 674.
banks. (Hopefully, in the case of new offerings, the expiration dates do not occur before the dates upon which a closing under the plans are likely to occur.)

The commitment letters (and accompanying disclosure statements) require the applicants to pay the expenses incurred by the bank in making the loans, generally including the bank’s attorneys’ fees and the cost of the title searches and title insurance (if required).24 Query: should

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24 For a variety of reasons, lawyers have dealt with cooperative apartments for many years as if it were perfectly clear that a transfer of a cooperative apartment involved nothing more than the transfer of marketable securities. Specifically, suggestions that an “apartment transfer” involved the sale of real property or quasi-real property were deemed to have no merit.

After the decision in In the Matter of Lacaille, 44 Misc. 2d 370, 253 N.Y.S.2d 937, supra note 3, which involved a contest over the priority of liens on a tenant-shareholder’s interest in a cooperative, and which held that state tax liens are perfected against cooperative shares and a proprietary lease in the same manner in which such liens are perfected against real property, more thought was given to the matter. Many attorneys thought that the decision in this case was harmful merely because it seemed to import “real property” concepts into the area of cooperative apartments. This sentiment led to the introduction of legislation which sought to declare that cooperative apartments are personal property for all purposes. The bill was passed by both houses of the legislature, only to be vetoed by the Governor who, quite rightfully, decided that the matter required further consideration and analysis.

Since Lacaille, however, it was realized that even if “a cooperative apartment” is personality, it is possible that the “apartment” might be encumbered in such manner as to make a purchaser or lender subject to adverse claims and interests that are matters of public record.

An attempt to limit the more obvious risks in this regard was made by the development of standard public record search procedures. Under these procedures, searches would be made for various liens and encumbrances including, in particular, federal and state tax liens, which might affect the owner-seller-borrower directly, as well as mechanic’s liens and notices of pendency which might affect him indirectly because they relate to his apartment. Overnight it became standard practice to make lien searches (including searches for financing statements) upon the transfer of a cooperative apartment. Similarly, attorneys representing clients about to lend on the security of cooperative apartments also began to make such searches.

At the time the search procedures were developed, one abstract company was prevailed upon to handle requests for such searches on a routine, fixed fee basis. Thought also was given to the desirability of encouraging the use of title insurance. To be sure, a cooperative apartment owner owns a leasehold estate—and that is insurable. Experienced practitioners decided not to obtain title insurance in the case of apartment purchases for several reasons. First, because careful records of apartment transfers are kept by the cooperatives’ own managing agents, which also closely supervise the mechanics of every transfer, and because very few cooperative apartment loans (other than sponsor loans) have been made, the risk of outstanding claims seemed remote—and the risk of mistake by the abstract company even more remote. Also, problems arising out of forgeries, incompetency, infancy or insanity were virtually non-existent. Second, aside from insuring that the search of public records was accurately made, it was by no means clear that title insurance would insure the most “serious” risk faced by a purchaser of (or lender on) an apartment, i.e., liens affecting the shares rather than the lease. Title insurance, after all, does not insure ownership of shares of stock in a corporation. Indeed, title insurance company search procedures are not designed to reveal the existence of such liens in all instances. Thus, one might take title to shares only to find out, at a later date, that the shares were affected by adverse interests on the date they were acquired. Even if the adverse interests resulted in a default under the proprietary lease, the title insurance policy would be useless because title insurance does not insure against termination of a lease-
not closing costs be waived or limited to nominal amounts when a bank is making numerous loans under a cooperative plan? Perhaps, also, the maximum amount of the closing costs should be limited in all events to the amounts shown in the disclosure statement since there may be a temptation (at least for the present) for bank lawyers to "overdo" the examination of the cooperative and the preparation of loan documents because of unfamiliarity with the collateral.

At least one commitment letter requires the borrower to effect casualty insurance coverage satisfactory to the bank.  

Some commitments are contingent upon receipt by the banks of satisfactory appraisals of the apartments being purchased. (In the case...
of a "refinancing" this condition will be mandatory.) No indication is given whether the appraisals are being made by bank personnel or by independent appraisers. At least one commitment makes the bank's obligation contingent upon "credit approvals."

Each of the commitment letters indicates that a security interest in something relative to the apartment will be required. One commitment refers to a "pledge" of the "certificates of stock" and an assignment of the proprietary lease under a loan-security agreement; another says that the loan will be secured by a leasehold mortgage and security agreement covering stock and related proprietary lease; a third also refers to a pledge.

One commitment letter indicates that the proceeds of the loan "shall be disbursed directly to the seller of the cooperative apartment for your account. . . ." This is particularly useful when the purchase is being made under a cooperative plan since the closing of the purchase will take place, without the borrower's physical presence, simultaneously with the closing of all other share purchases under the plan. Also, it assures compliance with the statutory requirement that the proceeds be used to finance the purchase of the shares and lease which permits the bank to make a 9% loan. Another commitment letter "confirms" the representation made by the borrower that "the proceeds of the loan will be used to purchase certificates of stock in, and the proprietary lease of the captioned apartment from, the corporation owning the premises. . . ."

None of the letters, however, seems to contemplate an advance of loan proceeds before the actual date of closing under a cooperative plan. Since all cooperative plans require a "final payment" on a purchase agreement to be made before the cooperative's own closing, there is a "gap" to be closed. The 1972 legislation authorizes a bank to advance loan proceeds as much as 90 days before it obtains an assignment of the stock certificate and proprietary lease, so that there is no legal impediment to more flexible commitment terms in this regard.

All commitment letters provide for approval by the banks and their counsel of the proprietary leases to be assigned; some also require approval of the cooperative's certificate of incorporation and by-laws.

Of greatest significance is the provision found in every savings bank commitment letter which makes it a condition of the bank's obligation that the cooperative enter into an agreement with it which will afford protection of the bank's interests, as a lender, which may (and, at present, are likely to) transcend those already allowed by the proprietary lease. One commitment letter spells out, in detail, the sub-
stance of that agreement. Another refers to a "Recognition Agreement" annexed to the commitment. Although the substance of these agreements will be discussed later in this article, it is important to note that, as a practical matter, virtually every applicant for a loan from a savings bank (unlike an applicant for a loan from the commercial bank that has entered the field) will require help from an attorney in order to comply with this condition. Until the terms of these bank-cooperative agreements are more or less uniform and mutually satisfactory to cooperatives and banks, it will be a difficult matter for a loan applicant—who is not yet a tenant-shareholder of the cooperative—to satisfy the bank in this regard.

Indeed, to the extent that a commitment letter requires that the cooperative's organizational and proprietary lease documentation afford to the bank broad, generally described rights with respect to the holding, acquisition and disposition of collateral after default, or that a cooperative enter into an agreement with a bank affording such rights, the commitment may be worthless because, in all probability, it is impossible for the applicant to comply with the requirements, as stated.

At present, few if any cooperatives seem willing to engage or pay counsel to review the agreement that each bank has prepared and to negotiate any required changes. If the bank is willing to reimburse the cooperative for its legal costs whether or not an agreement is reached, this problem might disappear. If, however, the bank decides to pass such costs on to its borrowers, loan applicants during the next few years may find themselves saddled with considerable closing costs. The author, as counsel to a cooperative, recently reviewed well-prepared loan documentation with a savings bank, at the bank's request, only to find that the cooperative's legal fees, calculated solely on the basis of customary time charges, amounted to more than $1,000.

Beyond the problem of legal fees, few if any cooperatives will be willing to accept, without modification, the "belt and suspenders" technique being employed by some savings bank counsel who have prepared documents solely with a view to "protecting" their clients. Since the cooperative is a third party to a resale transaction, there is little chance that either a bank, the tenant-shareholder selling an apartment (and thereby proposing to disassociate himself from the cooperative) or the loan applicant (who does not yet have any relationship to the cooperative) will be able to persuade the cooperative's counsel that the cooperative should simply sign on the dotted line unless counsel is convinced that his client will not be unduly burdened or incur undue liability by reason of its becoming a party to an agreement with the bank.
Depending upon the willingness of the cooperative to facilitate bank lending arrangements and the bank’s own willingness to accommodate legitimate interests of the cooperative, the loan application may be suspended between immovable forces. While this may be inevitable, it may also be that the loan applicant has naively relied upon the issuance of a bank loan commitment in agreeing to purchase an apartment, or in selling the house or apartment in which he resides at the time of contract (in anticipation of his purchase), or, at the very least, in agreeing to reimburse the bank for the legal fees and expenses incurred by the bank in its attempt to close the loan. Again, the applicant-apartment purchaser needs competent counsel, which means additional legal fees (even if the transaction is not consummated).

There is no easy solution to this problem. The savings banks are entitled to decide, on a case-by-case basis, the terms on which they are willing to lend their money. At the same time the cooperatives are entitled to resist what they regard to be unnecessary limitations on their prerogatives and their control over their own property, or attempts by banks to put them at their peril if they fail to “cooperate” fully with the banks in the event of defaults. Loan applicants, who have no control over the banks or the cooperatives are entitled to a bona fide attempt by all concerned to “work out” concepts and documentation. Perhaps the only realistic solution lies in an attempt by the cooperative apartment industry, which has a very great stake in assuring the availability of conventional financing of cooperative apartments, to bring about a degree of uniformity of concept and documentation and to share, together with the banking industry, the cost of negotiating the terms of agreements which should be acceptable to both cooperatives and banks. An attempt towards this end is being made by The Cooperative Housing Lawyers Group, an association of attorneys in New York City who specialize in the organization and representation of cooperatives. It is too early to determine whether the attempt will be successful.

Bank-Cooperative Agreement

Attorneys preparing new cooperative plans are developing organizational documents and proprietary leases that anticipate bank demands for protection against loss of the security which they will obtain upon making cooperative apartment loans or undue interference with the banks’ ability to dispose of their collateral readily after a borrower’s default. The task is not an easy one because there is no consensus among the savings banks with respect to the protections which they will require. Moreover, in each instance, the problem of reconciling
the interests of the cooperative and those of the bank depends, in some measure, upon the nature of the building to be operated by the cooperative.

For instance, in a multi-building conversion plan involving more than a thousand apartments, there is every reason to give an established savings bank which agrees to make loans to all existing tenants almost uncontrolled discretion in choosing the individual to whom it will transfer an apartment upon "foreclosure." This is not a cooperative in which exclusivity of tenants, considered in terms of economic or social homogeneity, is likely to be of material importance to anyone. The diverse economic, educational and social backgrounds of the existing tenants, the great size of the project, the modest cash investment being made in the shares of the cooperative by each purchaser, the importance of the availability of financing to existing tenants, the unpretentious neighborhood (as likely as not) and, perhaps, the anticipated continuance of management control by the company long affiliated with ownership of the property before conversion, are all factors that lead to the conclusion that the interests of the cooperative and its tenant-shareholders will be adequately protected even if there are no legal restrictions on the right of the bank to transfer its collateral to any individual after a borrower's default.

On the other hand, if it is being proposed that a cooperative acquire a 12-story building located on Fifth Avenue and having one apartment on each floor, and if the shares allocated to each apartment will be sold for something like $250,000, no one would be inclined to allow any lender unlimited rights with respect to the transfer of collateral upon foreclosure. Indeed, in such a case, a cooperative plan is unlikely to give banks any special rights whatever in this regard.

The problem of reconciling the conflicting needs of banks and cooperatives is even more difficult with respect to existing cooperatives. Contrary to the assumption made by some attorneys representing savings banks that a cooperative may freely enter into almost any kind of an agreement with a bank as long as the agreement is approved by the cooperative's board of directors, several of the most basic protections being insisted upon by the banks may be granted by a cooperative only if they are authorized by at least an absolute majority of all of the cooperative's tenant-shareholders. Although the board of directors of a cooperative is responsible for the general management of the cooperative's affairs, the board is bound by the terms of the cooperative's by-laws and proprietary leases which, in almost every instance, require that all proprietary leases made by the cooperative be in the same form
unless the form itself is changed upon the approval of something between 66-2/3% and 80% of the tenant-shareholders.

So, if a savings bank requires the cooperative's agreement that it be permitted to assign a defaulting borrower's shares and proprietary lease to anyone the bank may designate (or anyone that may be approved by the managing agent of the cooperative), the bank is asking for a right that actually contravenes the restrictive assignment provisions of the form of proprietary lease used by the cooperative which make it the duty of the directors or shareholders to pass upon all transfers. It follows that no such right may be given to the bank unless the form of proprietary lease used by the cooperative is amended; conversely, absent such amendment, the grant of any such rights to a bank by the board violates a material agreement made between the cooperative and all of its tenant-shareholders. Assuming that the board's duty to pass upon the qualifications of prospective tenant-shareholders is fundamental to the cooperative scheme, it is probable that existing tenant-shareholders may obtain injunctive relief to prevent the cooperative's board from ignoring or delegating that duty. Indeed, if (as likely) the certificate of incorporation and by-laws of the cooperative require the board to consider all transfers, the agreement between the cooperative and the bank may be ultra vires, and the directors who authorized it may be found to have violated their fiduciary obligations to the tenant-shareholders. Even if that were not true, it may be anticipated that a volunteer board of directors, elected years after such a bank agreement is authorized (by directors long since replaced), may feel compelled either to challenge the bank's actual assertion of its right to assign its collateral without the cooperative's consent or to refuse recognition of the bank's assignee as a tenant-shareholder. The threat of litigation, difficulties in proof of the lender's damages for failure of a cooperative to honor its agreement and the general breakdown of cooperative-lender relationships which would almost certainly result from such litigation, might well give one pause.

Such problems are avoidable if counsel to the cooperative, after negotiating an agreement with one or more lenders which is acceptable to the cooperative's board of directors, submits the agreement to the tenant-shareholders for approval at an annual or special meeting of the shareholders. If the tenant-shareholders are properly advised of the desirability of encouraging institutions to lend to purchasers of the cooperative's shares, and the board and its counsel have exercised good judgment, the shareholders may be expected to approve the proposed documentation. There are, however, two practical problems to this ap-
COOPERATIVE APARTMENTS

proach: First, it would seem desirable to develop documentation that will appeal to more than one bank before submitting it to tenant-shareholders for approval. Second, what happens to the applicant for a cooperative apartment loan during the time it takes to obtain the approval of the bank's documentation by the board of directors of the cooperative and the approval of the tenant-shareholders?

The Lenders' Requirements

One savings bank summarizes the protections it wants in its commitment letter. The bank makes it a condition of its obligation to lend that:

The proprietary lease used by the cooperative "shall be satisfactory to the Bank and its counsel and shall provide (a) that the lease is assignable to a lender, (b) the shares of stock of the corporation evidencing ownership of the apartment [sic] are transferable and (c) such shares of stock can be pledged with a lender in connection with a loan for the purchase of said apartment;" and that

The cooperative agree directly with the bank "(a) that the cooperative corporation shall give written notice of any default under the lease to the Bank, (b) the cooperative corporation will, in the event the Bank takes possession of the apartment, accept rent from the Bank, (c) that the cooperative corporation will not cancel, modify or terminate the lease, (d) that the cooperative corporation will, in the event of the default of any of the terms of the loan, terminate the lease at the request of the Bank and take such steps that are necessary to promptly obtain possession of the apartment for the Bank and (e) in the event the Bank acquires the apartment pursuant to the terms of the loan agreement, they [sic] be permitted to sell the shares of stock and assign the lease covering said apartment with the approval of the managing agent without requiring the written consent of the Board of Directors."

Although the language of the first paragraph reprinted above is broad and, in some respects ambiguous, it would seem that the thrust of the paragraph is a demand (1) that the bank be assured that the making of a loan secured by a security interest or mortgage lien in the shares and proprietary lease will not, of itself, constitute a default under the terms of the lease (and that any necessary consent thereto be given), and (2) that the cooperative have no right of first refusal with respect to proposed sales of shares and leases that would prevent the bank from realizing, upon the sale of its collateral following a default by its borrower, an amount equal to its loan. More it cannot mean — if the bank seriously intends to make cooperative apartment loans. Although few
proprietary leases specify that they are assignable only to "individuals," as that term is used in Section 216 of the Internal Revenue Code of 1954, the almost arbitrary right of the board of directors of the cooperative to refuse consent to a transfer is almost always used to prevent assignments to corporations, partnerships or other entities which are not such "individuals." The reason is that unless sufficient shares are owned by "individuals," it will be impossible for a cooperative to comply with the condition, imposed by section 216, that 80% of its gross income be derived from individual tenant-shareholders, with the result that all of its tenant-shareholders would be deprived of their right to deduct, on their own individual income tax returns, proportionate shares of mortgage interest and real estate taxes paid by the cooperative.

For this reason, counsel to cooperatives may be expected to insist that, under no circumstances, will the bank (a corporation) ever be permitted to acquire shares and leases directly or through a nominee. This does not mean that, with the consent of the board of directors or its managing agent, the bank, as foreclosing lender, may not assign the shares to an individual at public or private sale. While the bank's inability to acquire title to the collateral may create some practical problems for the bank (if, for example, it is unable to sell the collateral for an acceptable price immediately after default and is unwilling to allow title to remain in its defaulting borrower until such a sale can be arranged), by and large the banks have acknowledged the importance of the matter to a cooperative and have been willing to accept the risk.26

The "agreement" contemplated by the second paragraph reprinted above is predicated on the notion that the cooperative's proprietary lease does not afford the lender any of the protections it contemplates. This may or may not be true. Until proprietary leases are changed to reflect current bank requirements, it is probably true to a substantial degree.

A lender on the security of a proprietary lease is certainly entitled to ask for a copy of any notice of default sent to its borrower, as lessee, under the lease. Although a few attorneys representing cooperatives assert that any requirement that the cooperative send a copy of any such notice to the bank places a great burden on the cooperative, which is not a direct beneficiary of the bank's loan, the objection is without merit — unless one takes the position that a cooperative should not do anything to help its tenant-shareholders borrow from banks.27 The re-

27 At least one bank, in an extraordinary show of flexibility, has been willing to accept
quirement, however, unlike that set forth above, should be limited to the sending of duplicates of formal notices of default; the cooperative should not be expected to "police" the performance of lease obligations by a tenant merely in order to enable it to inform the bank of its borrower's failure to perform an independent agreement with the bank to honor lease obligations. Default notices are rarely sent out by cooperatives, and then only when serious defaults have come to the board of directors' attention. "Reminders" may be sent out with respect to overdue rent, but these are not notices of default which permit the termination of a proprietary lease for non-payment and a cooperative should not incur liability for any failure to inform the bank, in effect, that the tenant-borrower is not paying rent on time and may be experiencing financial difficulties. Conditional limitation notices, which are always prepared by counsel to the cooperative upon specific request of the board of directors, are sent only in aggravated situations. It is not difficult for the cooperative or its counsel to be sure that a copy of the notice is sent to a lending institution that has notified the cooperative of its security interest in the lease and appurtenant shares. Indeed, the sending of a duplicate notice to a lender often will be the best way of enforcing payment of overdue rent by a recalcitrant tenant-shareholder because, in general, tenant-shareholders may be expected to take notices received from cooperatives less seriously than those received from banks having the right to accelerate loans because of continuing rent defaults. Given the fact that the mere existence of a bank, as lender on a cooperative apartment, provides the cooperative with what amounts to a guarantor of the tenant's obligations under his lease (since, in many instances, the bank is not likely to permit loss of its security because of non-payment of rent or non-performance of the tenant's other obligations), the obligation to give a duplicate notice is an inconsequential burden — and the cooperative's risk (which probably is the ineffectiveness of its default notice) — a small price to pay for active involvement of banks in cooperative apartment financing.

The requirement that the cooperative accept "rent from the Bank," however, is not necessary, unless it merely refers to rent tendered for the account of a tenant-borrower. Acceptance of checks from a bank will not create a section 216 problem for the cooperative since the bank is not the proprietary lessee and the money, accepted for the account of the borrower, is "qualified income" from the tenant-shareholder.
Similarly, the rent may be accepted from an individual designee of the bank who acquires the lease upon foreclosure and who may be holding the apartment for resale—provided that he is not a mere nominee of the bank.

The requirement that the cooperative not “cancel, modify or terminate the lease” also is too broad.

The cooperative may agree to refrain from terminating the lease because of default if, within a reasonable time after receiving a notice of such default, the bank cures same for the account of its borrower. The cooperative may also agree to enter into a new lease with the bank's individual designee after termination of the borrower's lease because of a noncurable default (e.g., bankruptcy) or a default which the lender does not attempt to cure (e.g., repeated failure to honor house rules) because it does not have possession of the apartment. But it cannot responsibly agree that, under no circumstances, will it terminate a lease that is in default.

Again, the cooperative may be compelled by vote of its shareholders (in accordance with its by-laws and proprietary lease) to modify the borrower’s lease. Although at least one thoughtful commentator has pointed out that, absent an express provision to the contrary in the proprietary lease, no such modification can bind a tenant-shareholder without his consent, the bank certainly needs no more than a binding contractual commitment that no such modification will be made which might adversely affect its rights, as lender, or make more burdensome its obligations. Finally, in respect of this point, while the cooperative may agree not to accept a voluntary lease surrender (except in lieu of termination by conditional limitation notice), it will be compelled to terminate the lease if the borrower-tenant exercises his right to cause such a termination under the “escape clause” found in every proprietary lease. Again, the issue is not termination—it is notice to the lender of a proposed termination and an obligation by the cooperative to enter into a new lease with an individual designated by the lender.

A requirement that the cooperative terminate the borrower's proprietary lease if there is a default under the bank's security agreement, and obtain possession of the apartment for the lender, raises special problems beyond the obvious fact that all proprietary leases must be amended to so provide. By this requirement the bank hopes to avoid the practical problem created when the borrower fails to pay debt service but continues to pay rent to the cooperative and to reside in the apartment. The bank will want to obtain possession of the apartment
in order to show it to prospective purchasers and to resell the shares and proprietary lease at the highest market price (i.e., with immediate occupancy of the apartment); but a lender, as such, may not bring summary dispossess proceedings. Section 611(3) of the Real Property Actions and Proceedings Law (R.P.A.P.L.) which, in effect, prevents a mortgagee from obtaining possession before foreclosure. Although many sponsors of cooperative plans which have provided "retail financing" of shares have imposed similar obligations upon cooperatives, it seems hardly likely that a bank will be allowed to destroy the redemption rights afforded by the Uniform Commercial Code to a debtor or by R.P.A.P.L. to a mortgagor by the simple expedient of enlisting the cooperative's help in terminating the borrower's lease and dispossessing him. Presumably, if the borrower has fully honored all of his obligations, as lessee, to the cooperative, the cooperative has no business using its power to forfeit the tenant's estate solely to enable a lender to avoid initiating prescribed foreclosure or other proceedings as a condition precedent to obtaining possession. On the other hand, if the borrower's rights have been duly foreclosed, there appears to be no reason why the cooperative cannot undertake to obtain possession of the apartment for the purchaser of the borrower's shares. While the purchaser may be able to obtain possession without the cooperative's assistance, the cooperative's assistance is certainly useful. Perhaps the problem is not as great as banks seem to believe. It would seem reasonable to suppose that a borrower who fails to pay debt service will not pay rent (maintenance charges) either since, generally, the rent will be much greater than the debt service. In this situation the borrower is likely to vacate the apartment voluntarily, failing which possession can be obtained by the cooperative as a consequence of the tenant's default under his lease.

The final requirement, that the shares and lease of the defaulting borrower may be resold without the consent of the board of directors provided that consent is given by the managing agent, has already been discussed. Suffice it to say that, in addition to the necessity of amending all proprietary leases to so provide, this requirement may or may not be reasonable under the circumstances.

One savings bank has developed an ingenious procedure which

28 See "Proposed Legislation" infra p. 677. A device sometimes used to avoid this problem is a "double sublease," one between the borrower, as landlord, and the lender or its designee, as tenant, and the other between the lender or its designee, as landlord, and the borrower, as tenant, each signed "in blank" when the loan is made. By creating a landlord-tenant relationship, the lender may evict its "tenant." The author has been advised that the device has been used successfully. It is, however, a sham and ought to be disregarded by the courts if contested.

will permit it either to prevent a termination of its borrower's lease for non-payment of rent or to allow a termination of the borrower's lease without causing an immediate reissuance of the lease to an individual designated by it (upon foreclosure), and, in the meantime, to provide the cooperative with a source of funds equal to last rent without risking loss of the cooperative's section 216 status because of receipt of rent from the bank. This bank's agreement with the cooperative provides that if the bank does not wish (a) to make payments for the account of the defaulting lessee (its borrower), or (b) to require immediate issuance of a new lease to an individual after termination of its borrower's lease, or (c) to require the individual transferee of the lease to pay rent during a portion (or all of) the period that such individual holds the apartment for resale, the bank will lend to the cooperative sums equal to the rent and other payments that would be required to be made by the lessee under the proprietary lease for the period involved until ultimate resale of the shares and lease. The cooperative is given the right to withhold approval of the resale unless it receives, out of the resale proceeds, an amount equal to the balance of its loan (including interest owed to the bank), or its indebtedness to the bank is otherwise satisfied.

Other items of interest in proposed bank-cooperative agreements include the following:

(1) an acknowledgment of notice of the bank's loan and an agreement to send required notices to specific bank personnel;

(2) a direct confirmation of the cooperative's obligation to honor provisions of its proprietary lease designed to protect the bank, as lender;

(3) a recognition of the bank's right to pay rent, for the account of its borrower, out of escrows created under loan documents;

(4) an agreement by the cooperative not to consent to any transfer of the collateral without the bank's consent;

(5) an agreement by the cooperative not to enter into any agreement with a subordinate lender on the same collateral or to consent to a junior lien;

(6) an acknowledgment of the collateral assignment to the bank of any distributions that might be made by the cooperative to the borrower;

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30 The bank may not want to litigate with its borrower over the propriety of making rent payments on the borrower's behalf for an extended period.

31 This may occur because the resale market is "soft" and the bank is unable or unwilling to sell its collateral at prevailing market prices.
COOPERATIVE APARTMENTS

(7) a request that notices of repeated non-payment of rent for extended periods be sent to the bank even if the cooperative has not yet decided to send a notice terminating the proprietary lease of the bank's borrower;

(8) an agreement that one who purchases shares after "foreclosure" and who holds the shares for resale (and who does not occupy the apartment) may "escape" liabilities under the lease at any time on reasonable notice rather than once a year (as generally provided in proprietary leases);

(9) a confirmation by the cooperative that, insofar as it knows, the borrower owns the apartment;

(10) a confirmation by the cooperative of the amount of rent (maintenance charges) payable for the apartment, and the non-existence of defaults under the proprietary lease; and

(11) an agreement by the bank to permit the cooperative to acquire an apartment of a defaulting tenant-shareholder subject to the bank's loan, pending resale.

The Promissory Note

The promissory note being used by several savings banks is negotiable in form; at least two banks, however, incorporate the terms of the security agreement into the note, thereby rendering it non-negotiable. The notes generally provide for late charges and for acceleration in the event of a default under the security agreement. Prepayment rights vary, depending on each bank's lending policy.

Security Agreement

One of the first savings bank loans to be made after the enactment of the new law employed a security agreement that closely followed the form of security document previously used by sponsors who financed the sale of shares under cooperative plans. Not long before, counsel to at least some sponsors had come to the conclusion that a "security interest in a proprietary lease" is a leasehold mortgage by another name, and had begun to use the term "security interest-mortgage lien" in loan documentation to indicate an intention to create an encumbrance under all applicable laws, including not only the Uniform Commercial Code (which probably applies to cooperative shares and which might apply to a proprietary lease), the common law (which may apply to cooperative shares and a proprietary lease) and the Real Property Law and Real Property Actions and Proceedings Law (which should apply to the proprietary lease). Although this form of security agreement was
not meant to be recorded prior to the occurrence of a default, it con-
tained an agreement that, if it were to be recorded in due course, the
borrower would pay the mortgage tax. In order to qualify for a partial
exemption applicable to the first $10,000 of the amount of the mort-
gage, the agreement stipulated that if section 253(2) of the New York
Tax Law were applicable, the agreement should be deemed a "mort-
gage . . . of real property principally improved" by a "one . . . family
residence or dwelling." 32

The document required the borrower to represent, inter alia:

1. that he owned the shares and proprietary lease in which the
   bank obtained a security interest;
2. that no prior transfer or assignment of the shares or lease
   had been made;
3. that the shares and lease were free of adverse claims, liens
   and encumbrances; and
4. that no lawsuits or proceedings were pending against the
   borrower which could have an adverse effect on the loan trans-
action.

The borrower also was required to agree that he would honor his ob-
ligations to the cooperative; that he would do anything needed to per-
fect or preserve the bank's interest in the collateral; and that the bank
would be entitled to a receiver in any action to enforce its rights under
the security agreement without regard to the adequacy of the security
held by it.

Events of default included:

1. nonpayment of interest or principal after expiration of the
   applicable grace period;
2. nonpayment of rent (maintenance charges) or other
   charges under the proprietary lease after the expiration of any
   applicable grace period provided in the lease;
3. default by the borrower in the performance of any of the
   other obligations of the lessee under the proprietary lease;
4. the giving of a notice of termination or cancellation of the
   proprietary lease by the cooperative;
5. the existence of any unbonded judgment against the bor-
   rower for thirty (30) days after entry;
6. the insolvency or bankruptcy of the borrower, or the

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32 An unrecorded mortgage takes precedence over judgment liens filed after the mort-
gage is made and delivered. Recording is useful, therefore, not only to obtain a judgment
and judicially-supervised sale that cut off the borrower's equity of redemption, but also
to eliminate from the records subsequently filed liens on the shares and stock. Sullivan v.
Corn Exchange Bank, 154 App. Div. 292, 139 N.Y.S. 97 (2d Dep't 1912), cited with approval
in Suffolk County Federal Savings & Loan Ass'n v. Geiger, 57 Misc. 2d 184, 291 N.Y.S.2d
982 (Sup. Ct. Suffolk County 1968).
making of an assignment of the borrower's property for the benefit of his creditors, or the appointment of a receiver for the borrower or any of his property;

7. the making of any subordinate security interest or lien in the shares or the proprietary lease;

8. the subletting of the apartment without the bank's consent (which the bank agreed not to unreasonably withhold if the subletting were approved by the cooperative);

9. the discovery of any misrepresentations in the loan documentation; and

10. the failure of the borrower to honor any of his obligations under the loan documentation other than nonpayment of debt service.

The security agreement provided that if an Event of Default should occur,

... the Secured Party, in addition to any and all rights which it might have hereunder, or pursuant to the Uniform Commercial Code, or under the Real Property Actions and Proceedings Law, or otherwise ...
erative. The borrower also agrees that until the indebtedness is paid in full he will not avail himself of his right to terminate his proprietary lease pursuant to its "escape clause."

A set of the bank's loan papers was distributed to virtually every other savings bank in New York City. As a result, some savings bank counsel began to embellish upon the original documentation, while others began to consider whether the traditional sponsor financing approach was adequate and appropriate for bank loans.

One major savings bank, which was primarily interested in lending to purchasers under cooperative plans, found both the approach and the type of documentation basically acceptable. Its counsel used similar sponsor financing forms as a model and produced substantially the same result as the first bank. This bank's loan documents, which were not quite so sophisticated as the first and which ignored the leasehold mortgage aspect of the loan transaction, were circulated widely and samples were given to several hundred bankers who attended a Banking Department conference on the new law. As a result, they are being used by many other institutions, without material change.

The principal variation on the common theme is found in the security documentation used by a single large savings bank (and copied, in approach, by at least one major commercial bank for employee loans).

Proceeding from the assumption that the creation of a security interest in a proprietary lease amounts to the creation of a leasehold mortgage lien, this bank uses not only a security agreement affecting the cooperative shares and proprietary lease but also a separate and distinct mortgage indenture encumbering the leasehold estate created by the proprietary lease, together with personal property used in respect of the apartment.

The use of a mortgage, as already suggested, is not merely an application of the "belt and suspenders" technique. "Real Property," as used in the Recording Act, includes chattels real (except a lease for a term not exceeding three years). A "conveyance" required to be recorded includes "every written instrument, by which any estate or interest in real property is created, transferred, mortgaged or assigned, or by which the title to any real property may be affected . . ." (except a lease for a term not exceeding three years). While this does not necessarily mean that "an assignment or transfer of . . . stock . . . and a proprietary lease" under section 235 of the Banking Law is "a mortgage on real property," it does seem to make inevitable the appli-

33 N.Y. REAL PROP. LAW § 290(1) (McKinney 1968).
34 Id. § 290(3).
cability of the mortgage recording tax to the document creating a security interest in a proprietary lease.\textsuperscript{35} Taken a step further, it would also seem to indicate that in order to foreclose the borrower's equity of redemption in the leasehold estate (at least), a mortgage foreclosure action\textsuperscript{36} or a mortgage foreclosure by advertisement\textsuperscript{37} is required. If that is true, then the requisite collateral assignment under Section 235 of the Banking Law does involve, at least in part, a real property mortgage.

Although a security agreement need not be denominated "mortgage" to be considered one, and mortgages need not follow the statutory form,\textsuperscript{38} it may well be that an attempt to foreclose a mortgage which is not in statutory form will be faced with all sorts of obstacles resulting from unfamiliarity of the court and its personnel with the document. It is (a) because of this, (b) because of the expectation that there should be no difficulty in obtaining an appointment of a receiver who can obtain possession of the property in accordance with usual foreclosure practice, and (c) because of the usefulness in bringing a foreclosure action that can eliminate judgment liens entered after the date of the loan from record, that the savings bank has decided to use a formal mortgage document.

In substance, the mortgage is similar to those customarily employed in relatively small leasehold mortgage transactions. It contains, however, acceleration and default provisions which would permit foreclosure if a default were to occur under the companion security agreement. Defaults not mentioned previously include:

1. the removal of personal property from the demised premises without the consent of the lender;
2. the condemnation of the building in which the apartment is located or the termination of all proprietary leases by the cooperative by reason of casualty damage; and
3. the commencement of a mortgage foreclosure action against the cooperative.

It is conceivable that the mere execution and delivery of a formal real property mortgage may later be taken as evidence of the intention or agreement of the parties to the loan transaction that the borrower's equity of redemption in the lease (at least) will be foreclosed only in the manner provided by the Real Property Actions and Proceedings Law. This risk, when added to the uncertainty already existing as to

\textsuperscript{35}See N.Y. TAX LAW § 250 (McKinney 1966).
\textsuperscript{36}N.Y. REAL PROP. ACT. & Proc. Law §§ 1301 et seq. (McKinney 1963).
\textsuperscript{37}Id. §§ 1401 et seq.
\textsuperscript{38}See N.Y. REAL PROP. LAW § 258 (McKinney 1968).
the proper legal classification of the collateral, may make it desirable
for the lender to bring a declaratory judgment action before disposing
of its collateral in order to determine which remedy (i.e., real property
foreclosure or personal property sale) it should pursue.

Notwithstanding the problems that may be created by the use of
an independent real property mortgage, however, it is the author's
judgment that the savings bank using it is properly attempting to deal
with the mortgage aspects of the transaction directly, and that the bank
wisely refused to follow the lead of a number of other institutions which
have chosen, for one reason or another, to ignore the "mortgage prob-
lem" entirely.

Consider also that it is by no means clear that the Uniform Com-
mmercial Code applies to a security interest in a proprietary lease. Sec-
tion 9-104(j) of the Uniform Commercial Code states that article 9 of
the Code does not apply "to the creation or transfer of an interest in or
lien on real estate, including a lease..." "Real estate" is not defined;
it may or may not be the equivalent of "real property" as that term is
used in the Recording Act; likewise, it may or may not include tenant-
shareholders' "cooperative interests in realty."^9 The reference to "a
lease," on the other hand, is clear enough; a proprietary lease is unmis-
takably a "lease." Thus, on the face of it, the creation of a security in-
terest in the proprietary lease, as distinguished from an interest in
cooperative shares, is not governed by article 9 of the Code.40

_Ancillary Documents and Procedures_

Each bank requires its borrower to sign, in blank, a stock power
and assignment of proprietary lease. Under the terms of the security
agreement, the bank is authorized to complete these instruments upon
sale of the collateral to a third party after default. The forms of stock
power and lease assignment are standard to the cooperative apartment
industry except that they do not contain a covenant of title. Whether
well advised purchasers will insist on title indemnities from the lender
or a title insurance company remains to be seen.

It would appear to be the intention of all savings banks to file UCC
financing statements. This is clearly the better practice because, given
the present state of the law, it is not possible to determine whether

Dep't 1971), which held, somewhat surprisingly, that a contract for the sale of cooperative
shares and a proprietary lease, and the seller's right to retain the down payment made
thereon after the purchaser's default, was governed by article 2 of the Code because the
contract involved "goods."
mere possession of the share certificate and proprietary lease perfects a
security interest in the shares and/or the lease. Since at least two banks
are requiring a security interest in "all fixtures and articles of personalty
now or hereafter affixed to or used in connection with the apartment"
in order to keep the apartment intact and thereby preserve the value of
the shares and lease, financing statements may be required in any event.
Filing should be made in the Albany office of the Department of State
and in (a) the county in which the borrower resides ("consumer goods"
theory), (b) the county in which the apartment is located ("fixtures")
and (c) the county in which the borrower has his only place of business
("instruments" or "goods" theories).

At least one bank requires an affidavit of title from its borrower
containing, among other things, statements that the collateral has not
been pledged previously, that the apartment has not been damaged by
casualty, that the shares and proprietary lease are not subject to out-
standing tax liens, that the apartment is not subject to mechanic's liens
"and further that there has been no work done nor material delivered
to or upon the cooperative apartment to this date which gives any
mechanic or materialman the right to file a mechanic's or materialman's
lien against the aforesaid cooperative apartment." The affidavit is useful
in "smoking out" problems (assuming that the borrower is represented
by counsel who understands the import of the statements made therein).
It also supplements the search made, at the request of the lender, by an
abstract company or title insurance company for liens of record against
the seller and the purchaser. Although purchase money financing

If ownership of a cooperative is the ownership of "instruments" (which includes
"securities"), perfection of the security interest can be obtained only by possession of the
collateral. UNIFORM COMMERCIAL CODE § 9-304. Similarly, under section 9-305,
possession of the collateral will perfect a security interest if the owner's rights are classified as "goods"
(see Silverman, 37 App. Div. 2d 165, 523 N.Y.S.2d 39, supra note 40) although filing may be
necessary to protect against a resale of the collateral to a bona fide purchaser if the
collateral is "consumer goods." UNIFORM COMMERCIAL CODE § 9-307(2). If, on the other
hand, ownership of a cooperative apartment involves "general intangibles," perfection
can be only by filing. Id. § 9-302.

In the case of resales, the bank will want to learn of (a) any judgment and tax
liens filed against the seller which may affect the stock and proprietary lease, (b) the ex-
istence of UCC security agreements and financing statements which purport to create or
perfect security interests, (c) the existence of mechanic's liens resulting from work under-
taken in the apartment to be purchased which, under the terms of the proprietary lease,
may become the obligation of the borrower, and (d) whether there are insolvency or
bankruptcy proceedings pending which impair the seller's ability to transfer the shares and
lease. The bank will also learn from the official records whether there is a recorded chain
of title to the apartment (which would be rare), whether there are any mortgages of
record on the proprietary lease (which would be even more rare), and may supplement
its examination of the cooperative's own financial condition (as revealed in certified fi-
nancial statements) by verifying the terms of mortgages affecting the cooperative's prop-
erty, the existence of any notices of pendency of actions against the cooperative or
mechanics' liens for improvements made to the building. Such searches are readily avail-
generally takes precedence over liens previously filed against the borrower, the bank probably does not wish to lend to a person who is in financial trouble.

It would seem that the bank would be even more interested in obtaining such an affidavit from the party who is selling the cooperative apartment about to be financed. One bank does require such an affidavit, supplementing the covenants of title frequently contained in the assignment documents and the lender's own search for liens. Whether the borrower is able to persuade his seller to give an affidavit of title if the sale-purchase agreement does not so provide is, of course, another matter.

Although the loan documents do not so provide, it may be presumed that bank counsel for the lender will verify, for himself, the proper closing of the purchase of the apartment by the bank's borrower. Clearly the bank is no less concerned than its borrower that the borrower receive an estoppel letter from the cooperative indicating that all rent (maintenance charges) and other charges payable with respect to the apartment have been paid to the date of closing, that stock transfer and any applicable sales taxes are paid and that the new stock certificate is duly issued and proprietary lease duly made and that both are delivered directly to the bank.

**Proposed Legislation**

Brief experience with the 1971 legislation has already indicated the need or, at least, the desirability of additional legislation to help to fully effect the State's intention to develop institutional "home-mortgage" financing of cooperative apartments. The 1972 legislation dealt with several important problems. Among the additional changes to the law that might be considered are the following:

**Priority Matters**

1. Inclusion of lenders and/or their designees within the class of persons who may bring summary dispossess proceedings in order to obtain possession of an apartment occupied by a defaulting tenant-shareholder. If a lender may foreclose in five days under the Uniform Commercial Code by private or public sale, without a formal foreclosure proceeding, it should have the right to obtain possession speedily in order to offer possession to prospective purchasers of the collateral.

able from at least one abstract company in New York City for $75. The same company will continue its search to the date of closing of the loan, make tax searches against the cooperative, obtain departmental violation searches and provide analysis of the record for $125. See note 24 supra.
Prospective purchasers do not want to buy lawsuits; ancillary proceedings for the appointment of receivers are wasteful. If no sale can be made speedily, the lender should be able to sublease the apartment in order to cover rent and other sums payable to the cooperative. A bill to amend the Real Property Actions and Proceedings Law (Senate 8984) was introduced in the 1972 legislative session but not acted upon.

2. Clarification of article 9 of the Uniform Commercial Code, the Real Property Law and the Real Property Actions and Proceedings Law in order (a) to make clear the requirements for creating and perfecting security interests-mortgage liens in respect of shares and proprietary leases, (b) to set forth filing and/or recording requirements for liens affecting cooperative apartments and rules relating to the priority of such liens, and (c) to set forth the remedies of the lender in the event of a default.

3. Amendment of section 216 of the Internal Revenue Code so as to eliminate the “80-20” problem that might be caused in unusual circumstances or in a depression by the banks' acquisition of a great many cooperative shares and proprietary leases after foreclosure of apartment loans. The rent (maintenance charges) paid by banks under such proprietary leases should be disregarded for “80-20” purposes just as rent paid by government agencies, as owners of cooperative shares, is now disregarded.43

In Due Course

1. Definition of such terms as “a corporation or partnership formed for the purpose of the cooperative ownership of real estate” and “a proprietary lease.”

2. Expansion of the present law to permit long-term savings bank financing of 75% of the cost of improvements made to an apartment as well as 75% of the purchase price of the shares and lease allocated to the apartment. Renovation of first offer cooperatives after conversion is often desirable but costly. If 25% minimum equity is required insofar as the shares are concerned (unlike the 10% required in respect of single family houses), additional financing is both prudent and necessary.

3. Clarification of the Insurance Law to permit apartment owners to insure, and to recover, the replacement value (or stipulated value) of their apartments, regardless of insurance coverage carried by the cooperative or the cooperative's obligations in respect of repair and restoration.

4. Authorization of title insurance companies to insure title to cooperative shares as well as proprietary leases. Although the shares may be "personal property," they are part and parcel of the apartment owner's property. Insurance covering the leasehold estate but not share ownership is inadequate.

Conclusion

As more people live in apartment houses and more apartment houses are built as cooperatives or converted to cooperative ownership, the demand for purchase money financing of "apartment" purchases becomes ever greater. It is the responsibility of the Legislature, in the first instance, and the Bar, in the second instance, to develop financing techniques that will make cooperative apartment financing as easy as single family house or condominium unit mortgage financing. Whenever possible, historical accidents and nice distinctions must be ignored. The distinctive interests of the lenders, borrowers, cooperatives and community are clear: the goal is to accommodate these not-too-different interests quickly and to achieve a result which is universally desired. The savings banks are making a giant-step in the right direction. The commercial banks are just beginning to make their contribution. Although considerable effort and talent is needed to finish the job, there is no reason to believe that the development of institutional, purchase money financing of cooperative apartments well beyond its initial, somewhat primitive beginnings, cannot be accomplished with speed.