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DISCLOSURE AS CONSUMER PROTECTION: UNIT PURCHASERS' NEED FOR ADDITIONAL PROTECTIONS

VINCENT DI LORENZO

INTRODUCTION

Law is viewed as a dynamic system, evolving in response to changing conditions and experience. At times, however, legislative enactments become static—not responsive to change or to the lessons of experience. The New York statutes governing the creation of cooperative and condominium unit developments have fallen into this static mode. Over the years, changes have been made in protections afforded nonpurchasing tenants but the balance of the statutes have remained largely impervious to changing circumstances, particularly changes experienced by unit purchasers in the last decade. This article examines the need to rethink the legislative approach taken in New York toward protection of unit purchasers in offerings of condominiums and cooperatives—a full disclosure approach.

Part One of this Article studies the embrace of full disclosure as the legislative approach to protect unit purchasers. The findings are that the embrace was without much forethought. In addition, this approach has prevented the imposition of substantive protections by administrative regulation. Finally, the legislature has not subsequently reconsidered its approach, and instead has become path dependent.

Part Two explores the deficiencies of a pure disclosure approach in protecting unit purchasers. The New York experience since 1985 is the focus of the study. The findings are that the...
statute permits the unit purchaser to be placed at risk, unit purchasers have in fact been placed at risk, and disclosure has not served to protect them—either directly or indirectly, e.g., via the oversight of interested and experienced institutional participants.

PART ONE—FULL DISCLOSURE: CHANCE AND PATH DEPENDENCE

A. Theoretical Foundations

This article is a study of human decision making in the co-op—condominium context. In Part One, I explore legislative decisions. In Part Two, I explore individual human decisions. Professor Mark Roe recently studied corporate governance issues and suggested a refinement of the classical evolutionary model from law and economics "to accommodate three related concepts—one from chaos theory, another of path dependence, and a final one from modern evolutionary theory."2 A similar approach can form the basis for a study of legislative outcomes.

Chaos theorists have documented the existence of chance in choices among possible outcomes faced by physical systems,3 and opined a similar role for chance in human decisions.4 In physical systems the role of chance is the random choice which may occur at bifurcation points.5 In human decisions, particularly in the legislative arena, choices are rarely random. Some explanation is offered or can be surmised. Randomness, therefore, should be

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3 Ilya Prigogine and Isabelle Stengers, for example, discuss outcomes in physics in these terms:
   The “historical” path along which the system evolves as the control parameter grows is characterized by a succession of stable regions, where deterministic laws dominate, and of unstable ones, near the bifurcation points, where the system can “choose” between or among more than one possible future. Both the deterministic character of the kinetic equations whereby the set of possible states and their respective stability can be calculated, and the random fluctuations “choosing” between or among the states around bifurcation points are inextricably connected. This mixture of necessity and chance constitutes the history of the system.

ILYA PRIGOGINE & ISABELLE STENGERS, ORDER OUT OF CHAOS 169-170 (1984). In legislative decision-making the decision to embrace a legislative approach would be a bifurcation point.

4 See DAVID RUELLE, CHANCE AND CHAOS 90 (1991) (explaining how even rational decisions people make contain an irrational element).
5 See PRIGOGINE & STENGERS, supra note 3; RUELLE, supra note 4.
judged with reference to the purpose of the statute. If a choice is motivated by a desire to best serve the purpose of the enactment, then I would not characterize it as a product of chance. If the choice is not so motivated, however, I would characterize it as a product of chance.

Path dependence maps onto an initial legislative choice. As Professor Roe suggested:

Path dependence could explain the forms we see. Multiple, equally efficient results might abound and path dependence—paths shaped by a nation's political and cultural institutions, or chaotic chance events—could determine which among equally efficient end results we have. Or path dependence could permit structures that were once satisfactory to become inefficient but not be worth changing, thus rendering the path-determined structures regrettable even though they are left intact. Or path dependence could lead to highly inefficient structures that society cannot eliminate.6

Professor Roe views true path dependence as a decision to retain a particular approach or structure even though it yields inefficient results. I would take a different view. I would focus on the purpose of the particular enactment. If the approach or structure retained by the legislature poorly serves the purpose of the enactment, I would characterize its retention as path dependence.

Finally, modern evolutionary theory questions incremental change and instead recognizes the existence of sudden change in response to crisis.7 The legislative arena has experienced this same phenomena. Small changes have sometimes surfaced—changes which are departures from existing legislative paths. However, the metaphor of evolutionary theory alerts us not to assume that such small changes will be repeated and lead to an incremental evolution.

B. The New York Legislative Response

In 1960, the New York State Legislature was asked to choose a legislative approach for the protection of purchasers in offerings of cooperative and condominium units.8 The choice was

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6 Roe, supra note 2, at 646-47.
7 See id. at 663 ("Institutions and rules would be comparatively rigid until a shock hit the system. . . .").
8 New York did not adopt a condominium enabling statute until 1964, although
incorporated into the state's blue sky law (the Martin Act) and was a disclosure approach—full disclosure of risks and unit purchasers' self-protection by analysis of risks. As early as 1926, the purpose of the Martin Act was stated as being "to prevent all kinds of fraud in connection with the sale of securities . . . whereby the public is fraudulently exploited." The addition of the registration and disclosure requirements in 1960 was meant to serve this same purpose.

In 1988, the New York Court of Appeals confirmed what was long suspected—that the New York statute permitted the Attorney General to impose solely disclosure obligations and not substantive obligations, unless they were specifically imposed by the legislature. Many states applied the disclosure approach to the emerging unit ownership offering phenomena, although it was not universally adopted. California, for example, adopted an approach in which regulatory authorities sought to ensure suitability of a project for its intended use, fair dealing, and full disclosure.

The disclosure approach is also an approach which contrasts with the warranty protections New York enacted, more recently, for purchasers of newly constructed residential real estate.

other states enacted such statutes prior to this date. See 1964 N.Y. Laws 82.

9 See 1960 N.Y. Laws 987. The only substantive protection on the 1960 legislation was a requirement that moneys received from unit purchasers in connection with an offering be held in trust until consummation of the transaction. See id. at § 352-h.


11 See Council for Owner Occupied Hous., Inc. v. Abrams, 531 N.E.2d 627 (N.Y. 1988) (noting that New York's disclosure statute is intended to protect the public from fraudulent exploitation in the sale of real estate securities); All Seasons Resorts v. Abrams, 497 N.E.2d 33, 38 (N.Y. 1986) (deciding whether campground membership fell within the definition of a security so as to require registration); People v. Cadplaz Sponsors, Inc., 330 N.Y.S.2d 430, 432 (Sup. Ct. 1972) (stating that all acts tending to defraud the public fall within the scope of the Martin Act).

12 See Council for Owner Occupied Hous., Inc., 531 N.E.2d at 629 (invalidating regulations requiring sponsors to cure all building violations of record and eliminate all dangerous or hazardous conditions); see also Council for Owner Occupied Hous., Inc. v. Abrams, 511 N.Y.S.2d 966 (App. Div. 1987) (requiring sponsors to remove or treat asbestos in a related proceeding).

13 See JOHN PAUL HANNA, CALIFORNIA CONDOMINIUM HANDBOOK 2D § 10.1 (2d ed. 1986).

14 See 1988 N.Y. Laws 709. The statute applies to single family homes or units in a multi-unit residential structure of five stores or less. Thus, some condominium and cooperative offerings would be subject to the statute. The statute's warranties relate to physical defects, and not the terms of the offering regarding condominium or cooperative units, such as conditions of financing or minimum sales require-
Why was disclosure the legislative choice? The 1960 legislation was a response to abuses in the sale of real estate syndications—not cooperative unit offerings. The bill was part of the Attorney General's program bills. However, the Attorney General's memorandum to the Governor does not even mention cooperative unit offerings. Cooperative unit offerings were not the subject of the impetus for action and did not draw any attention from interest groups. Real estate syndication offerings are investment contracts, which, like other securities, have typically been subject to a disclosure approach for the protection of purchasers in federal and other states' securities laws. In other words, the New York decision reflects the history of the system of securities regulation generally. Cooperative unit offerings were added to the list of covered "securities" in the proposed legislation due to the decision of the Chief of the Securities and Real Estate Financing Bureau, who had witnessed abuses in sales of section 213 cooperatives. This policy advocate happened to be in charge of the state bureau responsible for both securities fraud and real estate fraud. Cooperative unit offerings are structured as stock offerings and, therefore, seemed reasonably subject to a disclosure approach in order to protect unit purchasers. Finally, there was a political realization that an addition to an existing bill—a bill which had, after earlier opposition, received the support of the real estate syndication industry—would facilitate action on the cooperative offerings measure.

This exploration of the history of the 1960 enactment indicates that the choice to subject cooperative offerings to the same approach as syndication offerings was not a deliberated choice by the legislature. However, it was considered and embraced by the policy advocate for the bill as a means of protecting unit purchasers. In that sense the choice was made without much study and forethought, but was not a random choice at a bifurcation


15 See Memorandum of the State Dep't of Law for the Governor (Apr. 5, 1960), in Governor's Bill Jacket to 1960 N.Y. Laws 987, at 1-2.

16 See id.


18 See id.
point. In addition, while not deliberated by the legislative body, full disclosure could have been viewed in 1960 as an effective mechanism to protect unit purchasers against abuses in unit offerings. As such, the initial choice of approach was not merely the product of path dependence. In the last ten years, the effectiveness of such an approach in serving the purpose of the Martin Act—to protect unit purchasers—has been cast into serious doubt. The legislature's refusal to modify the earlier choice of path could now be viewed as a product of path dependence.

California's contrasting embrace of a fairness approach reflects the history of the system in California, but also reflects more of a deliberated choice. California's blue sky law already had a history of requiring fairness in the terms of the offerings, rather than merely full disclosure. However, California specifically studied the various approaches which could be the basis for protection of unit purchasers in condominium offerings. There was a recognition that the complexity of condominium offerings and the degree of risks assumed by unit purchasers required the fairness approach to be adopted for condominium offerings as well, rather than the caveat emptor approach reflected in pure disclosure statutes.

In form, cooperative offerings are offerings of stock (plus a proprietary lease), although in substance they are offerings of ownership of real estate. In 1964, when the condominium enabling statute was being considered by the New York legislature, both the form and substance of the transaction was an ownership of real estate. However, disclosure, the choice previously embraced in 1960 for cooperatives, was the legislative ap-

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19 See Herbert E. Wenig & Royce H. Schulz, Government Regulation of Condominium in California, 14 HASTINGS L.J. 222, 231 (1963) (detailing the structure of California's corporate securities law).
20 See id.
21 See generally Philip J. Gregory, The California Condominium Bill, 14 HASTINGS L.J. 189 (1963) (describing the specific focus on the approach to be taken to regulate condominium offerings); see also Wenig & Schulz, supra note 19 (discussing the three approaches which have been taken to condominium offerings under existing law, and the choice needed to be made in proposed legislation).
22 See Wenig & Schulz, supra note 19, at 238.
proach followed.\textsuperscript{24} Again, there was little or no deliberation regarding the usefulness of this approach for this newly emerging real estate interest. The discussion in the Governor's Bill Jacket dealt with the need for enabling legislation and the decisions to be made regarding the structure of the condominium and the condominium association which was created.\textsuperscript{25} There was almost no discussion of the protections required, if any, at the offering stage.\textsuperscript{26} The one exception, which is in part a protection at the offering stage, was the prohibition against common liens except with the unanimous consent of unit owners.\textsuperscript{27} The Legislative Memoranda accompanying the bill explained that this would lower the risk faced by a unit owner by eliminating a major source of financial interdependence.\textsuperscript{28} Interestingly, even this action was not intended as an incremental evolution from a pure disclosure approach. Rather, at the time, the almost uniform state legislative response to financing of condominium developments was to prohibit common liens without unit owner consent.\textsuperscript{29}

Subsequent legislative activity did occur in New York. It was in response to crises. There was a nine year period of legislative turbulence, 1974-1983, with interim equilibrium points in 1974 and 1977-78. The crises concerned evictions of nonpurchasing tenants. The response was directed at that problem, and not at the possible need for additional protections for unit purchasers beyond disclosure.\textsuperscript{30} The first crisis response was in 1974 when, among other things, the Martin Act was amended to require 35\% of tenants to purchase before an existing residential

\textsuperscript{24} See 1964 N.Y. Laws 82 § 339-ee. This approach was sought by the same advocate in the Attorney General's Office who sought to subject cooperative offerings to disclosure requirements in 1960. \textit{See also} Di Lorenzo, \textit{supra} note 17, at 450.


\textsuperscript{26} See \textit{id}.

\textsuperscript{27} See \textit{id}.

\textsuperscript{28} See Memorandum of Joint Legislative Committee on Hous. and Urban Dev., 1964 New York Laws 1839.

\textsuperscript{29} See James L. Casey, Note, \textit{Board of Managers' Authority to Borrow Money}, 48 \textit{St. John's L. Rev.} 1122, 1128-29 (1974) (noting that Alabama and New Jersey have condominium blanket mortgage statutes, but enabling legislation in other jurisdictions requires consent of the unit owners).

\textsuperscript{30} See Di Lorenzo, \textit{supra} note 17, at 452-54 (discussing the motivations behind the 1974 legislation and forces which led to its passage). Curiously, unit owner groups actually opposed the legislation because it would discourage conversions.
building could be converted to cooperative or condominium status. The second crisis response was in 1978 and 1979, and was again in response to evictions faced by tenants, including senior citizens. The 1974 legislation expired in 1977 by its terms. In 1978, a revised statute aimed at protecting tenants was enacted. It retained a 35% tenant purchase requirement only if nonpurchasers were to be evicted. In noneviction plans, a 15% purchase requirement was codified. The only explanation for the choice of the 15% figure was that a project was not viable unless at least 15% of the units were sold. The purpose was a “viable” project—meaning one in which there was at least some evidence of marketability of the units. The decision that 15% would be the measure of viability was one negotiated by the Attorney General's Office with a developer (who wished to declare a plan effective upon sale of only one unit) before the 15% requirement was codified. It was then grafted onto the 1978-79 legislation. The choice was a compromise measure in exchange for legislative sanction for eviction plans with sales of only 35% of units to tenants, rather than a majority of units.

The legislative choice of a 15% figure is an example of what Prigogine and Stengers would call decisions at bifurcation points based on the history of the system and also on chance. The history of the system was the Attorney General's view of the minimum requirement for a viable entity. The existence of chance, as that term is applied in this article, was due to the fact that the legislative embrace was not based on a conclusion that the choice

32 See 1978 N.Y. Laws 544 (making the statue applicable in Nassau, Westchester and Rockland Counties, at local option). The legislative findings contained in the Acts stated that “it is sound public policy to encourage ... conversions while, at the same time, protecting tenants in possession who do not desire or are unable to purchase.” Id. at § 1; see also 1979 N.Y. Laws 432 § 1 (applying this provision in the City of New York).
34 See id.
36 See Interview with Daniel A. Furlong, Principal Attorney, New York State Dep't of Law, 1970-81, in Jamaica, New York (Oct. 23, 1997).
would best serve the purpose of the statute. Rather, it was based initially on a negotiated outcome with a developer (and thus, in part, an arbitrary choice) at a time when no minimum sale was required by law and, when followed in the legislative enactment, was based on political compromise, a minimum figure establishing viability in exchange for some tenant veto power over evictions.

The third crisis response occurred in 1982-83. At the time, the legislature faced a large number of protests due to a large number of conversions that resulted in evictions of tenants under a system in which a 35% minority decided the fate of all.37 In this period, tenants were again protected by legislative change, which now imposed a requirement that 51% of units must be sold to tenants before nonpurchasing tenants could be evicted.38 The 15% sales requirement for non-eviction plans was not changed.

Response to crisis does not always occur in the legislative arena. There exists a complex mix of factors which lead to action or inaction at any point in time. This has been the subject of my earlier work.39 This article does not examine the causes. It examines the outcome—inaction in response to crisis faced by unit purchasers in the late 1980s, evidencing path dependence. This is documented in Part Two.

PART TWO—A PURE DISCLOSURE APPROACH: UNIT PURCHASERS AT RISK

In this article, the deficiencies of a pure disclosure approach
in protecting unit purchases is explored through the sales experience in noneviction plans. Examination of the legal and economic environment during the past decade reveals that the cooperative and condominium developments which were created, were characterized by risk. The law permitted conversions with very few resident unit owners. It also combined with the economic environment to create disincentives to further vigorous sales. As a result, developments have been created which are cooperative or condominium in form only, which continue to be rental properties in substance. For the resident unit owners in such developments, the result has been large payments (for ostensible unit ownership) in exchange for denial of ownership prerogatives and exposure to excessive risk. The risk-creating environment is brought about by two related developments, documented below—the predominance of noneviction conversions and the declaration of effectiveness with few sales.

A. The Post-1985 Experience

1. Predominance of Noneviction Conversions

By the mid-1980s, most offering plans for cooperative or condominium ownership were able to be declared effective only as noneviction plans. This was the result of two related legal requirements. First, the requirement that 51% of tenants in occupancy purchase the unit in order to declare a plan effective as an eviction plan. Second, the requirement that for noneviction plans, only 15% of the units must be purchased in order to declare the plan effective. This trend was reported as early as 1983.
1983 by James M. Morrissey, Chief of the Real Estate Financing Bureau of the Attorney General's Office:

Since the enactment of the new conversion statute governing New York City, which became effective July 20, 1982, there has been a relative decrease in eviction plans submitted and a relative increase in noneviction plans. Our records show that the submission of eviction plans in New York City has decreased from 343 plans involving 28,229 units in 1981 to 248 plans involving 23,386 units in 1982 to 88 plans involving 7,424 units in the first nine months of 1983. Furthermore, we find that at least 40 to 50 percent of the plans accepted since July 20, 1982, as eviction plans are amended to become noneviction plans before they are declared effective.45

I studied this phenomena during the five year period 1985-1989, the last period during which significant offerings occurred in the State of New York. The computerized Plan Listing Report maintained by the New York State Department of Law was used as the source for data on the number of eviction and noneviction plans declared effective during the 1985-89 period. This is also the five year period during which most plans facing financial losses in the last decade were created. The Report lists individually the status of each plan. Aggregate figures were calculated based on these individual entries. Table A contains the results. It reveals that in the 1985-89 period, noneviction plans constituted more than 60% of the plans declared effective in 1988 and 1989, more than 50% in 1986 and 1987, and more than 46% in 1985.

<table>
<thead>
<tr>
<th>Table A</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>PLANS DECLARED EFFECTIVE</strong></td>
</tr>
<tr>
<td></td>
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<tr>
<td></td>
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<tr>
<td></td>
</tr>
<tr>
<td>--------</td>
</tr>
<tr>
<td>Noneviction</td>
</tr>
<tr>
<td>Eviction</td>
</tr>
<tr>
<td>Vacant “Residential” and “Commercial”*</td>
</tr>
</tbody>
</table>

45 Wedemeyer, *supra* note 42, at 7. This evidence deals with plans submitted. The results reported in this article contain data concerning effective plans state-wide. *See id.*
Split Eviction **

<table>
<thead>
<tr>
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<th></th>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Noneviction</td>
<td>30,279</td>
<td>25,626</td>
<td>38,586</td>
<td>31,499</td>
<td>30,199</td>
</tr>
<tr>
<td>Eviction</td>
<td>5,484</td>
<td>2,556</td>
<td>1,344</td>
<td>2,311</td>
<td>1,524</td>
</tr>
<tr>
<td>Vacant, &quot;Residential,&quot; and &quot;Commercial&quot;</td>
<td>5,971</td>
<td>9,062</td>
<td>9,938</td>
<td>8,389</td>
<td>7,363</td>
</tr>
<tr>
<td>Split Eviction</td>
<td>101</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total Number of Units</td>
<td>41,835</td>
<td>37,244</td>
<td>49,868</td>
<td>42,199</td>
<td>39,086</td>
</tr>
<tr>
<td>Units in Noneviction Plans</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Percentage of All Units</td>
<td>72.38</td>
<td>68.80</td>
<td>77.37</td>
<td>74.64</td>
<td>77.26</td>
</tr>
</tbody>
</table>

* The computerized Plan Listing Report designates plans involving property which is vacant—either newly constructed or rehabilitated—as "residential" or "commercial".

** At one time, the sales requirements to tenants to be achieved before declaring a plan effective as an eviction plan was separately applied to rent stabilized units and rent controlled units.

Moreover, as documented in Table B, in four of the five years in question, more than 70% of all units created were done so under noneviction plans.

2. Few Sales—the Rise of the Illusory Cooperative

In the 1985-89 period, sponsors declared many plans effec-
tive with very few units actually sold. The New York State Department of Law does not compile or report figures on sales achieved to declare offering plans effective. To compile such figures, monthly reports on individual buildings released by Yale Robbins, Inc. (based on individual review of each amendment to each offering plan) were analyzed. The period analyzed was again the five year period preceding the first reports of financial difficulties—1985 to 1989. During this period, Yale Robbins reported information on 1,082 offering plans, containing 82,938 units, which were declared effective. These individual entries provided the source of information regarding the percentage of units actually sold before plans were declared effective. Table C contains the data which was compiled. In each year, one-half or more of all plans were declared effective with less than 25% of units sold. In fact, in 1988 and 1989, more than two-thirds of all plans were declared effective with less than 25% of units sold.

<table>
<thead>
<tr>
<th>Year</th>
<th>15%</th>
<th>20%</th>
<th>25%</th>
<th>30%</th>
<th>35%</th>
<th>50% or more</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of Plans</td>
<td>46</td>
<td>48</td>
<td>23</td>
<td>7</td>
<td>28</td>
<td>36</td>
</tr>
<tr>
<td>Percentage</td>
<td>24.47</td>
<td>25.53</td>
<td>12.24</td>
<td>3.72</td>
<td>14.89</td>
<td>19.15</td>
</tr>
<tr>
<td>Number of Units</td>
<td>3,423</td>
<td>4,985</td>
<td>2,947</td>
<td>995</td>
<td>3,877</td>
<td>3,129</td>
</tr>
<tr>
<td>Percentage</td>
<td>17.68</td>
<td>25.75</td>
<td>15.23</td>
<td>5.14</td>
<td>20.03</td>
<td>16.17</td>
</tr>
<tr>
<td>1986</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of Plans</td>
<td>45</td>
<td>28</td>
<td>14</td>
<td>9</td>
<td>21</td>
<td>22</td>
</tr>
<tr>
<td>Percentage</td>
<td>32.37</td>
<td>20.14</td>
<td>10.07</td>
<td>6.48</td>
<td>15.11</td>
<td>15.83</td>
</tr>
<tr>
<td>Number of Units</td>
<td>3,517</td>
<td>1,926</td>
<td>673</td>
<td>959</td>
<td>2,385</td>
<td>1,890</td>
</tr>
<tr>
<td>Percentage</td>
<td>30.99</td>
<td>16.97</td>
<td>5.93</td>
<td>8.45</td>
<td>21.01</td>
<td>16.65</td>
</tr>
</tbody>
</table>

The 1,082 plans for which Yale Robbins, Inc. reported sales information represent 34.78% of all offering plans which were declared effective in the 1985-89 period. The 82,938 units contained in such plans represent 39.45% of all units for which plans were declared effective during that period. See The Coop/Condo Conversion Digest Newsletter, Plans Declared Effective, Comparison of Initial and Final Deal by Building (Yale Robbins, Inc., New York, N.Y. 1985).
3. Policy Implications

(a) Deny Unit Purchasers Self-Management

The rise of cooperative or condominium developments with few resident unit owners denies such unit purchasers a voice in self-management. At the board level, the sponsor or other non-resident investor controls the selection of board members and board policies. At the unit-owner level, the sponsor or other non-resident investor controls decisions made at shareholder-unit owner meetings. A voice in self-management has been recognized as a right that is at the heart of the cooperative (or condominium) form of ownership.47 As the New York Court of Ap-

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peals explained, when sanctioning an arbitrary right of consent for unit transfers, that "there is no reason why the owners of the co-operative apartment house could not decide for themselves with whom they wish to share their elevators, their common halls and facilities, their stockholders' meetings, their management problems and responsibilities and their homes."48

The loss of self-management is not ameliorated by legislative protections. In New York State, there is no legislative requirement that the sponsor relinquish control of the board of a cooperative or condominium after a specified time.49

The Attorney General's office has issued a regulation limiting board control in conversions to: (a) two years after the closing, in eviction plans, or whenever unsold shares (units) constitute less than 50% of the shares (common interests), whichever occurs sooner, and (b) five years, in noneviction plans, or whenever the unsold shares (units) constitute less than 50% of the shares (common interests), whichever occurs sooner.50 The power of the Attorney General to impose this limit is not clear, although it has not yet been challenged. Moreover, courts have interpreted the regulation to merely prohibit the sponsor from designating a majority of the board.51 There is no requirement that a majority of the board be elected by unit owners other than the sponsor.

(b) Create At-Risk Developments

After declaring a plan effective, the sponsor becomes the

48 Weisner v. 791 Park Ave. Corp., 160 N.E.2d 720, 724 (N.Y. 1959) (holding a cooperative sales agreement void where there was no approval by the cooperative corporation).
49 Other states do limit developer control over the board. Florida, for example, requires a certain percentage of board members to be elected by "unit owners other than the developer." FLA. STAT. ANN. § 718.301(1) (West 1988); id. § 719.301(1) (limiting developer control to a maximum of seven years); see also UNIF. CONDOMINIUM ACT § 3-103(c) & (d) (1977).
50 See N.Y. COMP. CODES R. & REGS. tit. 13, §§ 18.3(y)(5), 23.3(w)(1) (1995). In newly constructed or vacant structures, board control is limited to two years or whenever unsold shares (units) constitute less than 50% of the shares (common interest), whichever occurs sooner. See id. §§ 21.3(s)(1)(xii), 20.3(u)(1).
51 See Park Briar Assocs. v. Park Briar Owners, Inc., 582 N.Y.S.2d 273, 274 (App. Div. 1992) (stating that the Attorney General's regulation does not alter such conclusion); Rego Park Gardens Assocs. v. Rego Park Owners, Inc., 570 N.Y.S.2d 550, 551 (App. Div. 1991) (indicating that a sponsor's voting rights are valid absent proof that the elected board members were on the sponsor's own slate or received compensation from the sponsor).
owner of the unsold units and is required to meet the financial obligations which attach to those units. A significant financial drain was created in some developments, particularly cooperative developments, since rents received by the sponsor for unsold units were far below the monthly maintenance payable to the cooperative housing corporation. This is especially true for units that are subject to rent stabilization—almost all of the converted units within the City of New York. For example, at Hyde Park Gardens, Kew Gardens Hills, New York, the difference between rents received and maintenance payable, on 489 unsold units, was $112,177 per month. At Boulevard Gardens, Woodside, New York, the difference, on 543 unsold units, was $98,192 per month. In these developments, the sponsors eventually defaulted due to an inability to make up this shortfall over an extended period of time. In times of high demand, the market prevented sponsor default. Unsold units were sold at a profit on a continuing basis and such profits offset the financial drain caused by units yet unsold. However, when the market no longer provided this safety net, sponsors were forced to default on maintenance obligations owed to the cooperative corporation.

My study of financial difficulties focuses on the period of time between 1989-93. During this time period serious financial difficulties surfaced, and unit owners lobbied for legislative intervention. By 1989, the risk of loss documented above was transformed into actual and significant losses for a large number of individuals. The number of sponsors defaulting on maintenance obligations is supplied by filings made with the New York State Department of Law, Real Estate Financing Bureau. On December 12, 1989, sponsors were alerted to the need to file an amendment to offering plans in the event of a default in their financial obligations. In January of 1990, it was reported that

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52 See Lim, supra note 41, at 355 (explaining the sponsor's responsibility to make payments on the units it retains).
54 See Fifteenth Amendment to Offering Plan, Boulevard Gardens Complex, May 31, 1990.
eighty-eight buildings faced financial difficulties due to sponsor defaults. By May of 1990, this figure rose to 235 buildings. In December of 1990, the figure had become 300 buildings, and then rose to 325 buildings by March of 1991. By March 1993, the New York State Department of Law had been notified of approximately one thousand buildings and developments in the State in which there were financial problems.57

Due to these financial defaults and difficulties, unit purchasers were placed at risk and in some cases lost their equity investment. First, some cooperative housing corporations were unable to pay debt service on underlying mortgages. This led to some foreclosures. Foreclosure of an underlying mortgage in a cooperative development leads to the dissolution of the cooperative.58 Unit purchasers lose all property rights, both their equity investment and their leasehold interest as unit purchasers. However, if they financed the purchase of the unit, they remain personally liable to repay the unpaid balance of their debt. Thus, they suffer an actual out-of-pocket financial loss at least equal to the purchase price of their unit. In recent years, several foreclosure proceedings have been completed.69 Attorneys estimate that hundreds of cooperatives defaulted on their under-

58 See Peter Grant, Foreclosures Deepen Crisis in N.Y. Co-ops, Crains N.Y. Bus., Mar. 11, 1991, at 1 (explaining the agreement in the legal community that, upon foreclosure, the co-op dissolves and the building returns to a rental).
69 See Federal Home Loan Mortgage Corp. v. New York State Div. of Hous. and Community Renewal, 854 F. Supp. 151 (E.D.N.Y. 1994) (involving an 86 unit cooperative at 101 Lincoln Road, Brooklyn, N.Y.) aff'd, 83 F.3d 45 (2d Cir. 1996); De Santis v. White Rose Assoos., 578 N.Y.S.2d 363 (Sup. Ct. 1991) (involving purchasers of a 24-unit cooperative who lost their investment); Shawn G. Kennedy, For Troubled Co-ops, the Workout Rx N.Y. Times, May 24, 1992, § 10, at 8 (discussing two foreclosures); see also Brooks supra note 55, at 1 ("If the troubled buildings go into foreclosure or bankruptcy, buyers could be left with worthless investments, something that has not occurred in New York since the Depression . . . ") (quoting Harold Lubell, Chairman of the Co-op and Condominium Committee of the Real Property Section of the New York State Bar Association); Trouble in the Heights: Co-op Bankruptcy, N.Y. Times, Feb. 9, 1992, § 10, at 1 (discussing what is believed to be the first bankruptcy of its kind in New York City, in which the co-op corporation at 867 West 181st Street in Manhattan filed for protection from its creditors under chapter 11). Actually, in the 1970s, a cooperative located at 2 East 86th Street, the Hotel Adams, was subject to a foreclosure sale, and by agreement the former cooperative units reverted to rent stabilized status. See Daniel Wise, Foreclosure Ordered for East Side Co-op; Sponsor Defaults on Mortgage Payments, N.Y. L.J., Feb. 13, 1991, at 1.
mortgages, and the New York State Attorney General's Office reported that, as of March 1991, ten lenders had initiated foreclosure actions.\(^\text{60}\)

Second, unit purchasers have seen their equity interest in the cooperative—their interest above the unpaid balance on unit loans—vanish.\(^\text{61}\) This is due to steep cuts in offering prices for yet unsold units, and public unwillingness to purchase into developments plagued with financial difficulties. Often, the steep price cuts have resulted from lending institutions "foreclosing" on unit loans secured by unsold units pledged by sponsors. The total number of units to which lenders have taken title after sponsor defaults is unknown. One sponsor, Time Equities, reported that 3,200 of the 4,000 unsold units owned by it were taken by unit lenders.\(^\text{62}\) Another, Coronet Capital Corp., reported that 1,300 unsold units owned by it were taken by unit lenders.\(^\text{63}\) After taking title, the lending institutions sought to dispose of the units but were able to do so only at deep discounts. The deep discounts have not been temporary. While the market value of units has rebounded somewhat, the rebound has not restored unit purchasers' cash equity investment.

The market response has been reported in these terms:

The negative publicity surrounding the defaults increased buyer resistance and lender reluctance to finance unit purchases, and co-op prices went into free-fall... In some cases, prices dropped 50 percent or more from late-1980s highs.

Now, however, co-op prices appear to have hit bottom. And in scattered instances, they are starting to rise. At Crescent Woods in Bethpage, the price of sponsor-owned one-bedroom units sank from a peak of $90,000 to $40,000 in 1991, said Barbara Ford, president of Phase II Lifestyles Unlimited, a Floral Park business that markets co-ops. Today they start at about $60,000...\(^\text{64}\)

Evidence of loss of equity is provided by examining amend-
ments to filed offering documents with the New York State Department of Law. The experience at Hyde Park Gardens exemplifies the loss suffered by unit purchasers. That development was a conversion of a 764 unit complex to cooperative ownership. The offering plan was accepted for filing in September of 1986. It was declared effective in May 1987 with 120 units sold—16.15% of all units. The subsequent shortfall between rents received by sponsor on unsold units and maintenance obligations is documented above. As a result, the sponsor defaulted in payment of maintenance as of January 1989—with public disclosure of default, via an amendment to the offering plan, made in June 1989. This led to a default on payment of the underlying mortgage as of November 1989—with public disclosure of the default, via an amendment to the offering plan, made in August 1990. A workout ultimately was agreed to by the mortgagee, which also resulted in steep declines in the offering prices of unsold units. That decline is documented in Table D, which is based upon all promotions (price reductions, closing cost adjustments, and fix-up allowances) offered in the plan and any amendments until the plan was declared effective.

Table D

**HYDE PARK GARDENS**

<table>
<thead>
<tr>
<th>Description</th>
<th>Price Payable</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Lowest Price Payable By Purchasers</strong></td>
<td></td>
</tr>
<tr>
<td>On or Before Date Plan Declared Effective</td>
<td></td>
</tr>
<tr>
<td>- By Tenants $196.14 per share</td>
<td></td>
</tr>
<tr>
<td>- By Nontenants $222.20 per share</td>
<td></td>
</tr>
<tr>
<td><strong>Price Payable By Purchasers After Workout</strong></td>
<td>$135.00 per share</td>
</tr>
<tr>
<td>For Vacant Unit $135.00 per share</td>
<td></td>
</tr>
<tr>
<td><strong>Percentage Change on Sale Price</strong></td>
<td></td>
</tr>
<tr>
<td>Obtainable For Vacant Unit on Resale</td>
<td></td>
</tr>
<tr>
<td>- By Original Tenant Purchasers 31.17 percent decrease</td>
<td></td>
</tr>
<tr>
<td>- By Original Nontenant Purchasers 39.24 percent decrease</td>
<td></td>
</tr>
</tbody>
</table>

The decline evidenced in Table D is the minimum loss experienced, since it is based on the assumption of purchase at the lowest price offered at any time prior to the date the plan was declared effective. Some purchasers paid higher prices, both be-

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fore and after the plan was declared effective. The loss experienced—more than 31% for tenant purchasers and more than 39% for nontenant purchasers—would wipe out all of the unit purchasers' equity.

An argument could be made that the decline in prices was due in whole or in part to the general decline in demand as a result of the general downturn in the real estate market. However, the evidence does not support this conclusion. Table E compares the price paid by tenants at the time the plan for Hyde Park was declared effective, with subsequent prices offered for vacant units until the date a workout was arranged. This provides evidence of the effect of market changes on the investment made by a tenant-purchaser. Table F compares the price paid by nontenants at the time the plan was declared effective, with subsequent prices offered for vacant units until the date a workout was arranged. This provides evidence of the effect of market changes on the investment by a nontenant-purchaser. All figures are based upon the amendments filed to the offering plan.

| Table E |

**COMPARISON OF PRICES PAID BY TENANTS AND PRICES FOR NONTENANTS (VACANT UNITS) PRIOR TO WORKOUT**

<table>
<thead>
<tr>
<th>Date Prior to Declaration of Effectiveness</th>
<th>Price</th>
<th>Change from 1987 Price to Tenants</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987 (lowest price to tenants)</td>
<td>$196.14</td>
<td></td>
</tr>
<tr>
<td>May 1988 (price to nontenants)</td>
<td>$271.78</td>
<td>38.56% Increase</td>
</tr>
<tr>
<td>September 1988 (price to nontenants)</td>
<td>$279.40</td>
<td>42.45% Increase</td>
</tr>
<tr>
<td>June 1989 (price to nontenants)</td>
<td>$260.00</td>
<td>32.56% Increase</td>
</tr>
<tr>
<td>1990 (price to nontenants)</td>
<td>$260.00</td>
<td>32.56% Increase</td>
</tr>
</tbody>
</table>
Table F

<table>
<thead>
<tr>
<th>Date</th>
<th>Price</th>
<th>Change from 1987 Price to Nontenants</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987 (lowest price prior to declaration of effectiveness)</td>
<td>$222.20</td>
<td></td>
</tr>
<tr>
<td>May 1988</td>
<td>$271.78</td>
<td>22.31% Increase</td>
</tr>
<tr>
<td>September 1988</td>
<td>$279.40</td>
<td>25.74% Increase</td>
</tr>
<tr>
<td>June 1989</td>
<td>$260.00</td>
<td>17.01% Increase</td>
</tr>
<tr>
<td>1990</td>
<td>$260.00</td>
<td>17.01% Increase</td>
</tr>
</tbody>
</table>

Tables E and F document that both tenants and nontenants did not suffer a loss in their equity due to general market conditions—rather, market conditions would have caused them to suffer merely a decline in the overall appreciation in value they had earlier experienced.66

Steep price cuts have resulted not only from cuts introduced by lender, but from an inability to find buyers willing to purchase into a development plagued with financial difficulties. At times, resales have become impossible in the face of sponsor defaults. Evidence of this effect can only be provided by individual experience. For example, at Tudor City in Manhattan, after the sponsor reported financial difficulties meeting maintenance obligations, it was reported that the "[t]he initial reaction of the residents was terror.... For a year, you couldn’t sell a unit here."67 Similarly, at 305 Eighth Avenue, Brooklyn, New York, after the sponsor defaulted and maintenance doubled as a result, a unit owner reported that he did not even try to sell after being transferred to Rhode Island “’because nobody would even think

66 This conclusion is confirmed by aggregate market data on resales of condominium units—which have experienced far fewer sponsor defaults, in which sponsor default does not cause risk of foreclosure and loss by all unit owners, and for which reliable aggregate date is available because information on prices of all unit transfers is publicly available. Data gathered by Yale Robbins, Inc., on sales of condominium units in Manhattan, reveals that average unit sale prices declined slightly between 1989 and 1990, but were far higher in 1990 than they had been in 1988. See Alan S. Oser, Shedding the Landlord Role, Gradually, N.Y. TIMES § 10, June 7, 1992, § 10, at 5. In other words, for a pre-1988 unit purchaser there would have been only a loss of some of the appreciated value.

67 See Catalano, supra note 61, at 30 (quoting Mary Frances Shaughnessy, managing director of Tudor Realty Services Corp.).
of buying until we sort ourselves out.'

Third, unit purchasers have faced an inability to sell their units at any price. In part, this is due to the unwillingness of purchasers to purchase when a development is faced with financial difficulties, as discussed above. Additionally, it is due to lending institutions refusing to make loans secured by individual cooperative units unless the sponsor owns less than 50% of the units in the development. To document this second impediment, in February and June of 1992, I surveyed 117 bank and thrift institutions conducting a residential lending business within the City of New York. Responses were received from fifty-six institutions—47.86 percent. Of these, twenty-seven reported that they did not currently offer loans secured by individual cooperative units. Eight of the twenty-seven had offered such loans as of January 1990, but had discontinued making such loans. Of the twenty-nine respondents offering loans secured by individual cooperative units, twenty-five (86%) reported a loan policy requirement that 50% or more of the units in the cooperative must have been sold by the sponsor in order for a purchaser to qualify for financing. In fact, sixteen of the respondents (55%) reported that 70% or more of the units must have been sold to qualify for financing. At the end of March, 1993, I updated some of this data in preparation for field hearings on financing problems of housing cooperatives conducted by members of the House Banking, Finance and Urban Affairs Committee. At that time telephone follow-ups were conducted with the four financial institutions which had earlier indicated that bank pol-

68 Brooks, supra note 55, at 1 (quoting Randall Carnahan, insurance broker and former co-op president).

69 See Suzanne Christy, In a Class by Themselves, NEWSDAY, May 1, 1993, at 34 ("Most banks won't even consider financing a unit sale in a building that hasn't sold at least half of the units . . . .").

70 The reasons given for withdrawal from the market were: The difficulty of selling the loans in the secondary market, the dramatic decline in values, economic conditions and slowness of sales, a desire to further diversify the property held as collateral based on considerations of prudence in the current market, and a decision to respect portfolio lending to properties in the bank's CRA delineated lending area. The difficulty of meeting the requirement imposed by purchasers in the secondary market is due, in part, to the requirement that at least 70% of the units must have been sold to owner-occupants or second home purchasers. See, e.g., Federal National Mortgage Association, Selling Guide 846-49 (1993) (requiring 80% sales in Type 1 projects—in which lenders make final determinations that the project satisfies eligibility criteria—and 70% sales requirement in Type 2 projects—which are submitted to FNMA for review and acceptance).
icy did not prevent the making of unit loans when less than 50% of the units had been sold. As of March 1993, two of the four were no longer making cooperative unit loans, and one now required 70% or more of the units to be sold in order for a unit purchaser to qualify for financing. That left only one institution which would consider financing in developments in which less than 50% of the units had been sold, and even that institution indicated it was interested in making only a few cooperative unit loans.71

The risk of actual substantial financial loss should compel legislative activity before such losses and hardships result.72 The potential effect on tens of thousands of individuals would certainly justify legislative intervention. However, the legislature was not responsive in either case.

B. The Market As A Protective Scheme

A full disclosure approach relies on the market for protection of unit purchasers. The first line of protection should be the purchasers themselves, who assess the risks disclosed in a particular market transaction and voluntarily choose to assume those risks. The second line of protection should be afforded by institutional players who are needed for the market to operate, and who provide an assessment of disclosed risks and screen those which are excessive. The final line of protection should be the market itself, where future sales serve as a safety net for past

71 In response to two years of meetings with Queens Borough President Claire Shulman and field hearings called by Congressman Charles Schumer, a member of the Housing Banking Committee, the Federal National Mortgage Association (FNMA) unveiled a pilot program in October, 1993, which was limited to the City of New York. See Catalano, supra note 64, at D1. FNMA agreed to the purchase of co-op loans in the secondary market in which 51% or more of the units had been sold, but only if the development was otherwise financially sound. See id. (noting that in 1994 Fannie Mae changed its co-op underwriting guidelines, reducing the minimum percentage of units sold to 51% from 80%). The changes may help to make financing more available for some developments.

72 The precise number of units in buildings suffering financial losses due to sponsor defaults has not been calculated by the New York State Department of Law. The conclusion that losses were experienced by tens of thousands of unit owners is based on (a) the number of buildings which the Department of Law revealed had reported financial defaults—one thousand, and (b) the average number of units contained in offering plans that have been declared effective from 1985 through 1989—approximately 67.6 units per plan. There is a way to calculate the total number of units that remain unsold, but it is apparent that the number of unit purchasers in buildings suffering financial difficulties due to sponsor default is substantial.
risk assessments which are proven incorrect. The post-1985 experience with unit developments in New York State reveals that all three market-based protections failed. That failure calls into question exclusive reliance on a disclosure approach.

1. Can Unit Purchasers Protect Themselves?

Certain risks are unable to be adequately disclosed and assessed because their existence and scope are incapable of being known before the fact. For this type of risk, self-protection through disclosure is not feasible. At a minimum, New York's Martin Act should be amended to depart from a reliance on full disclosure for this type of risk. The sales figures in noneviction plans which unit purchasers must accept at closing is an example of this type of risk. What is disclosed is the minimum unit sales which permit the plan to be declared effective (15%) and the maximum sales (80%) requiring the plan to be declared effective. The actual sales in the development in which unit purchasers are legally bound to become a part is unknown and therefore undisclosed. It also cannot be adequately projected by the unit purchasers, due to lack of information and because sales experience will vary from building to building and from time to time.

There is no statutory right to rescind a unit purchase agreement if actual sales fall short of some stipulated amount, e.g., an amount which would ensure the financial stability of the building. Protection through rescission or raising the minimum sales required to declare a plan effective, are necessary substantive protections and would free purchasers from their reliance on a pure disclosure model.

There is another reason to depart from a pure disclosure model which applies to other types of risks, including those which can be disclosed. The experience in the field of condominium and cooperative unit offerings is that unit purchasers do not understand the risks disclosed in the offering plan. The difficulties faced by consumers who are asked to protect themselves by gathering and judging information, including consumers in the house hunting process, have been documented.73 One demon-

73 See Jeff Sovern, Toward A Theory of Warranties in Sales of New Homes: Housing the Implied Warranty Advocates, Law and Economics Mavens, and Consumer Psychologists Under One Roof, 1993 WIS. L. REV. 13, 14-23 (documenting the evolution of consumers' rights from the days of caveat emptor through the rules of
strated barrier to effective self-protection is information overload. This is prevalent in the coop-condominium purchase process, due to its reliance on a lengthy and, in part, complicated disclosure document (offering plan). Other barriers are probability assessments, which are essential in co-op/condominium offerings through predictions of future financial obligations.

Experienced individuals in the field of co-op/condominium offerings agree that individual consumers cannot be expected to understand an offering plan, and that they require expert assistance from attorneys, accountants, and real estate salespeople. While most buyers obtain the assistance of counsel, the assistance of other experts—e.g., accountants—is rarely sought. Moreover, given the cognitive barriers to appreciation of risks, one wonders if the assistance of counsel is effectively assisting purchasers in adequately perceiving and evaluating the risks of purchase. An example of disclosure not serving the purpose of individual perception and adequate assessment was recently provided. It dealt with the expiration of ten-year real estate tax abatement programs, which led to soaring condominium carrying costs.

Many buyers may not have understood that they would eventually have significant tax increases when the abatement expired, real estate lawyers said, despite requirements by the Attorney General's Office that the workings of the program be spelled out clearly to prospective buyers.

"Were they fully warned by the Attorney General?" asked Kevin B. McGrath, a partner at Graubard and Mollen. "Were they told by their lawyer? Yes and probably yes." "Did they understand it? Probably not," he concluded, adding that "human nature precluded their understanding it."

tort law until the relatively recent development of the doctrine of implied warranties).

See id. at 27-30 (suggesting that customers who are given a plethora of information in a short time often make less effective decisions).

See id. at 33-35 (informing that studies show many people assess probabilities by relying on heuristics, or approaches, that sometimes lead them seriously astray, thus, buyers often "choose not to purchase homes with warranties because they erroneously believe that their houses will not be defective.").

See George W. Goodman, To Understand a Prospectus, Experts Say, Get Expert Help, N.Y. TIMES, Sept. 13, 1981, § 8, at 14 (noting that it is a difficult task for a layperson to interpret a prospectus).

Tracie Rozhon, As A Tax Break for Some Condos Ebbs, Costs Soar, N.Y. TIMES, July 3, 1994, § 9, at 5.
2. Do Institutional Participants Protect Unit Purchases?

In securities regulation generally, it is sometimes admitted that the small investor does not understand the prospectus and, therefore, is not protected by a full disclosure approach. However, institutional participants and other sophisticated investors, are thought to understand the risks disclosed and to protect all others by their influence over the offering price. This is not true in offerings of condominium and cooperative interests.

Institutional participants in this market are the lenders who provide financing for the project, both unit loans and, in cooperatives, underlying mortgages. Such participants can shape the terms of the offering in order to reduce risks—e.g., establish a higher than 15% unit sales requirement to qualify for financing. However, unlike institutional participants in the securities market, these institutional participants are not cast in the same role as the small investor—they are not unit (securities) purchasers. As a result, they have no interest in self-management. Moreover, while they are interested in protecting their collateral, the protections they imposed in the pre-1989 period were not necessarily the requirements unit purchasers would need for protection of their investment. In part this was based on recent experience regarding market value. However, it was also based on market trade-offs, e.g., favorable financing decisions in exchange for additional fees or higher interest rates.

For example, before financial difficulties surfaced in 1989 not all lenders required evidence that sponsors’ financial condition was strong enough to make default unlikely. As reported in

78 See Homer Kripke, Where Are We On Securities Disclosure After the Advisory Committee Report?, 6 SEC. REGS. L.J. 99, 103-04 (1978) (noting that investors in the securities field, as determined by survey, functioned more like an analyst; however, it is also noted that the sample may have been unrepresentative and thus unreliable); Homer Kripke, The Myth of the Informed Layman, 28 BUS. LAW. 631, 632 (1973) (positing that “even an expert [could not] get a solid understanding as long as disclosure is circumscribed by the push to make the prospectus short and readable for the layman”); Peter D. Santori, Selling Investment Company Shares Via an Off-The-Page Prospectus: “Leveling the Playing Field” or “Diminishing Investor Protection”, 20 J. CORP. L. 245, 274 (1995) (recognizing that “in most cases and for various reasons, statutory prospectuses contain so much information that the average investor does not give the prospectus any review whatever, much less the review it deserves.”).

1990, "for the first time, some lenders are looking into the sponsor's finances when the number of unsold shares is high . . . . Lenders want to see if a sponsor's pockets are deep enough to continue paying maintenance fees." In addition, only after financial difficulties surfaced did most lenders require a high percentage of units to be sold. The secondary market long required 70 to 80% of the units to be sold, but lenders made loans to developments which did not meet these pre-sale requirements. As discussed earlier in this article, after 1989 lenders imposed a sale requirement of at least 50%. It was reported in 1991 that "[i]n situations where a sponsor owns 50 percent or more of the shares in a co-op, lenders are out of the market entirely . . . ."

Furthermore, lenders allowed sponsors to obtain loans secured by unsold units. They often valued those units based on the insider price. But, this was not universally true. Rather, "[w]hen the market was at its height two years ago [1988], many occupied units were financed for as much as 50 percent of the full market value they would have had if vacant. Now, many such units are worth even less."

3. Does the Re-Sale Market Protect the Unit Purchaser?

There are two distinct aspects to the resale market experience and its role in protecting unit purchasers. The first is the market experience faced by the sponsor. In the early 1980s, sponsors relied on future sales to generate revenues needed to meet the shortfalls between rents received and unit ownership obligations (maintenance or assessments). Few plans were

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51 See Alan S. Oser, Financing Is Available In A Variety of Forms, N.Y. TIMES, Oct. 28, 1984, at 45 (stating that for projects that do not meet Fannie Mae guidelines there is usually a quarter-point to a half-point additional cost to the loan).
54 Brooks, supra note 55, at 1.
55 See, e.g., Joe Catalano, Sponsor Defaults Growing Among Co-ops and Condos, NEWSDAY, Feb. 24, 1990, § 3, at 11. (explaining how rents on vacant apartments held by sponsors are lower than the maintenance charges thereby creating a negative cash flow).
noneviction plans.\textsuperscript{86} In 1981, the New York State Attorney General's Office reported that only about one in six conversions occurred pursuant to a noneviction plan.\textsuperscript{87} In eviction plans, non-purchasing tenants (other than senior citizens) could be evicted two years after the plan was declared effective.\textsuperscript{88} The right and power to evict, coupled with the market demand for units, allowed the sale of almost all units in a short time.

Even the plans which were noneviction plans allowed the market to operate. Sale of 30 to 40\% of the units occurred as a starting point\textsuperscript{89}—limiting the amount of shortfall for which a sponsor was responsible after declaring the plan effective. Subsequent sales occurred on an on-going basis, with a sell-out anticipated in seven to ten years.\textsuperscript{90}

The downturn in the market after 1987, however, impaired the effectiveness of this safety net. This led to the financial difficulties documented above, which, in turn, further eroded the market safety net as unit prices fell substantially and interest in unit ownership waned. By December, 1989:

Lawyers in the field made it clear... that the reasons sponsors are having trouble meeting their obligations when they have pledged their unsold shares is that in a slow market sales of those apartments that do become vacant are few and far between.

Without the sales... they lack the means to meet their obligations—to the banks that hold their unsold shares as security

\textsuperscript{86} See id. (discussing how negative cash flow is due in part to conversions done with noneviction plans).


\textsuperscript{88} See 1979 N.Y. Laws 432 (defining an eviction plan as "[a] plan which, pursuant to the provisions of any law or regulation governing rentals and continuing occupancy, can result in the eviction of a non-purchasing tenant by reason of the tenant failing to purchase pursuant thereto."); 1978 N.Y. Laws 544 (providing that "no eviction proceedings will be commenced against non-purchasing tenants for a period of two years after the plan is declared effective"). In 1982-83, the time period after which evictions could occur was changed to three years. One estimate, made in 1981, was that in buildings subject to eviction plans, about 15\% of the tenants move out, 80\% buy, and the remainder—5\%—are persons protected from eviction by law. See Brown, supra note 87, at 10.

\textsuperscript{89} See Alan S. Oser, The Noneviction Conversion Finds Favor, N.Y. TIMES, Jan. 9, 1981, § B, at 4 (citing experience of Robert Ettinger, a leading sponsor of noneviction conversions in describing his approach towards selling condominium units to tenants).

\textsuperscript{90} See id.
interest on loans and to the cooperatives for maintenance, which in many instances could be substantially in excess of the rental income from the tenants who declined to buy their apartments.91

The lesson of the 1980s is that the market safety net is unreliable. It works best when it is needed the least (when sales are brisk) and it fails when it is most needed.

A second resale market experience is the experience of the unit purchasers who find they have become a part of a very risky enterprise. Sale, at a partial or full loss, is the market's safety net. In the cooperative and condominium market, however, it is not a safety net in fact. First, as documented above, sales are not always possible at any price. Again, when the safety net is most needed, it vanishes. Second, loss means not just loss of a cash investment. There remains a large unit loan, typically two or three times as large as the unit purchaser's cash investment. Unit owners are often unable to discharge this large debt, making sale impossible even if a buyer is available.

One example of this phenomena was reported in 1995, many years after financial difficulties surfaced and unit prices dropped.

Despite... positive signs for the market, some co-op owners are still unable to sell and feel trapped. Charles and Linda Matson purchased a two-bedroom unit seven years ago for $72,000 at Village in the Woods in Selden. The Matsons estimate their unit is worth $25,000; the unit next door went for $20,000 last month at a foreclosure sale.

The Matsons have few complaints about the complex, which they say is financially stable and well maintained. However, the couple has two sons, and the family needs more space. Still, the Matsons have not tried to sell the unit, partly because they've seen few sales at the complex and partly because they have a $50,000 mortgage balance. If they sold for $25,000, they would have to pay another $25,000 to the lender to satisfy the loan.92

C. Path Dependence

Did the New York Legislature respond when confronted with the weaknesses of reliance on a market-oriented approach

92 See Catalano, supra note 64, at D1.
(premised on self-protection through disclosure)? Did it alter, even incrementally, reliance on a disclosure approach? In 1990 and 1991, unit owners, assisted by local government officials, lobbied for protective legislation. Yet the small measure of relief which was adopted in the years following the financial crisis which surfaced in 1989, was a bill allowing cooperative and condominium boards to collect rents directly from tenants when the unit owners (e.g. the sponsor as holder of unsold shares) default.

One recent bill, adopted in 1997, has recognized that unit purchasers require substantive protections, not merely the protection of disclosure. It authorized condominiums to obtain financing secured by common expenses. However, newly built or newly converted condominiums were not authorized to borrow in the first five years of their existence. The five year restriction was "meant to prevent a condo's sponsor...from making improvements, paying himself back and leaving the owners with a large debt. This happened to many co-ops in the mid-'80s, leaving them in financial trouble." This has been one departure from reliance on disclosure for protection of unit purchasers. However, past experience does not suggest this is a first step in an incremental evolution away from reliance on a disclosure approach.

Analysis of the reasons more protective measures were not passed is beyond the scope of this article. The outcome, however, evidences path dependence. Far fewer investors experi-

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53 See Di Lorenzo, supra note 17, at 466.
54 Id.
55 See 1991 N.Y. Laws 594; see also 1992 N.Y. Laws 104 (permitting any board member to file a lien for unpaid condominium charges); 1992 N.Y. Laws 172 (exempting a cooperative housing corporation from the New York gains tax when the sponsor defaults and it takes over the unsold shares).
57 See id.
59 See Di Lorenzo, supra note 17, at 465-66 (including the opposition of Senate leadership who believed the matter should be left in the hands of market forces rather than addressed through legislation).
enced losses in the late 1950s as a result of abusive real estate syndication offerings than experienced losses in the period after 1989 as a result of cooperative offerings without substantive legal protections. Yet, the former led to legislative action in 1960, while the latter led to relative inaction in the 1990s. Despite evidence that disclosure was not adequately serving the legislative purpose of protecting unit purchasers, the legislature did not depart from this legislative approach.

CONCLUSION

In 1960, New York embraced a full disclosure approach toward offerings of cooperative and condominium units to the general public. This decision was based on the history of securities regulation and a belief, at that time, that disclosure would adequately protect unit purchasers. In the last ten years, this belief has been contradicted by the facts. Yet, to date the New York Legislature has not departed from its historical path.

The need for departure from the disclosure approach is the message of this article. Yet, what sort of substantive protections should be adopted? This article proposes that the terms and conditions required for viable operation of a bona fide cooperative-condominium development should be stipulated rather than left to market forces. This includes financial soundness and effective self-management. A requirement that board control be in the hands of resident unit owners, which has been embraced in Florida and other states, is an example of a substantive protection which serves the goal of effective self-management. A requirement that a substantial share of the units must be sold, and that the sponsor provide adequate financial guarantees for warranties made in the offering, both of which have been imposed in California, are examples of substantive protections which serve the aim of financial soundness. The precise substantive protections to be adopted is a matter to be determined.

100 See CAL. CODE REGS. tit. 10, § 2792.9 (1998) (requiring eighty percent of interests to be sold, or providing security to assure fulfillment of the subdivider's obligations as owner).

101 See CAL. BUS. & PROF. CODE § 11018(i) (Deering 1984) (requiring "adequate financial arrangements" to be made "for any guaranty or warranty included in the offering"); see also CAL. CODE REGS. tit. 10, § 2792.14 (1991) (stating legal or financial arrangements shall assure that ownership and possession rights of a member of a stock cooperative are not adversely affected by foreclosure of blanket encumbrance when the member is not delinquent in payments).
The conclusion of this article, however, is that substantive protections are needed—departure from reliance on a pure disclosure approach is warranted.