

# SERVICING MANAGEMENT

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## FORECLOSURE

# The Dangers Of Co-Op Lending

*Associations Can Ride Roughshod Over Lenders And Servicers*

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**W**e have all heard tell that co-op lending is a dangerous arena. With co-op values having plummeted even more than traditional real estate, this is a place where the timid and the faint of heart need not apply, especially when it comes time to take the property back in a foreclosure.



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To be sure, the foreclosure methodology is decidedly easier for a co-op than it is for real estate, such as a house, a condominium or some commercial premises. Employing UCC Article 9 (the recommended approach) is a non-judicial procedure. Moreover, recent case law has finally ruled that a defaulting borrower's argument that a lender

should not have advanced maintenance to the co-op is a transparent defense.

But all this still leaves the myriad rules and the frequently unfettered authority of co-op boards to generally run amok, and in particular, to ride roughshod over lenders and servicers.

### *A paper of protection*

The recognition agreement (the document whereby the co-op acknowledges the position of the secured lender) is supposed to protect the secured creditor, i.e., the lender. And it does, but a new case (in New York) exposes the limitations of the recognition agreement in rather chilling fashion. [*Bank of New York v. Carr*, \_\_Misc.2d\_\_, 613 N.Y.S. 2d 572 (1994).]

In this case, the lender apparently eschewed the faster UCC foreclosure route, choosing instead to foreclose in the typical judicial manner of a mortgage foreclosure. Unfortunately, the co-op itself interposed an answer (which it might have had the opportunity to do even if the UCC method had been adopted), and that answer opposed the lender's motion for summary judgment. The court recognized immediately that the borrowers were in default of their obligation and that the co-op's lien for outstanding maintenance was senior to the lender's security interest.

### *The critical issue*

But there was a critical issue, whether a secured creditor was subject to the purchase option provisions of the co-op's bylaws and oc-

cupancy agreement which permitted the transfer of shares only upon a waiver by the co-op of its option to purchase the shares at book value.

The co-op's position - expressed in a counterclaim in the action - was that the lender must either accept book value for its security (the shares and the assignment of lease) in the paltry sum of \$4,726.27, or, pay a waiver of option fee to the co-op of \$7,500 to permit a sale to a third party.

The lender was faced with an obvious dilemma because either choice could be financially painful. So the question was, could the co-op impose this provision of the bylaws?

The court found that it could! Here was the reasoning.

Restrictions on the transfer of the lease and stock in a co-op's bylaws are clearly enforceable. Well accepted is the imposition of a waiver of option fee upon outgoing shareholders who desire to sell their shares in the open market rather than re-selling them to the co-op at book value. This is a valid exercise of a co-op's board's powers.

### *What the court said*

In the recognition agreement, the lender acknowledged the restrictions on transfer of the stock and proprietary lease by the following language, with emphasis supplied by the court:

"Notwithstanding any apparent authority granted to us under agreements with the Lessee, *we shall have no right or power to transfer the apartment upon foreclosure or otherwise to us or anyone else*

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without your approval as required by the lease provided, however, that nothing contained herein shall limit any rights we may have to dispossess the Lessee pursuant to law or realize our security in accordance herewith."

Confronted with the cited language, the lender's security interest was ruled subject to the option rights of the co-op because in enforcing its security interest, the lender could transfer to a purchaser no more than the borrower's rights in the collateral.

While in the end the foreclosure was allowed to proceed, the lender was burdened with the obligation to live with the restrictions and the bylaws. As a practical matter, that probably meant it would have to pay \$7,500 for the privilege of selling the co-op. With val-



ues as depressed as they are, this tribute would either eliminate the lender's ability to be made whole or, more likely, simply increase its loss.

The ultimate lesson presented is that ever more vigilance is required

when a co-op loan is originated. There isn't very much to be done to save the day under these circumstances in the foreclosure process.

Caveat lender!

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