BERGMAN ON MORTGAGE FORECLOSURES . . .

Bruce J. Bergman, Esq.**
East Meadow, New York

Still More Peril in the Co-op Loan*

Almost invariably finding no bidders at the co-op foreclosure sale is perhaps the most vivid message that these loans have potential for substantial risk. A letter from the co-op board to the secured lender advising of egregious maintenance defaults by the borrower/shareholder, to which have been added late charges and counsel fees — all to be paid by the lender — is another exemplar of the danger in this arena. And with co-op values having plummeted even more than traditional real estate, this is the 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.

To be sure, foreclosure methodology is much easier for a co-op than it is for real estate, such as a house, a condominium or some commercial premises. But this still leaves the myriad rules and the frequently unfettered authority of co-op boards to generally run amuck, and in particular, ride roughshod over lenders. The recognition agreement is supposed to protect the secured creditor, i.e., the lender. Although generally it does, a new decision exposes the limitations of the recognition agreement in rather chilling fashion.[1]

In this case, the lender apparently eschewed the faster, and recommended, UCC foreclosure route, choosing instead to foreclose in the typical manner of a mortgage foreclosure. Unfortunately, (from the lender's perch) 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 on their obligation and that the co-op's lien for outstanding maintenance was senior to the lender's security interest.

But there was a critical issue, whether a secured creditor was subject to the purchase option provisions of the co-op's bylaws and occupancy agreement which permitted the transfer of shares only upon a waiver by the co-op of its option to buy 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 would 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 reselling them to the co-op at book value. This is a valid exercise of a co-op board's powers.

In the recognition agreement, the lender acknowledged the restrictions on transfer of the stock and proprietary lease by the following language in the recognition agreement, 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 either to us or anyone else 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.

Given 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 then 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 values 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!

Endnotes

1. Bank of New York v. Carr, __ Misc.2d __, 613 N.Y.S.2d 572 (1994).

****Mr. Bergman, a partner with Certilman Balin Adler & Hyman in East Meadow, New York, is outside counsel to a number of major lenders and servicers and an Adjunct Associate Professor of Real Estate with New York University's Real Estate Institute where he teaches the mortgage foreclosure course. He is a member of the American College of Real Estate Lawyers and author of the two-volume treatise, *Bergman on New York Mortgage Foreclosures*, Matthew Bender & Co., Inc. (1995).**