

What's Up With Co-Ops? Documentation and Foreclosure



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Co-ops are unusual.

The papers look different and the method of foreclosure is (pleasingly) non-judicial — even in a judicial foreclosure state. And then there is the mysterious role and power of a stranger — the co-op board — all of which suggests that a review of this subject can be helpful. Indeed, because co-ops are so unusual, a common set of questions arises: What are they? What are the documents like? How do we service them?

What are Co-Ops?

Although more common in New York State, that odd creature called a co-op exists in other states as well. While located most often in urban areas, they can be found anywhere. And because they are so different from mortgages on real estate, it is extremely important for servicers to know what to do with them. Even though foreclosing on a co-op is more efficient, non-judicially, the bad news is the danger and lack of flexibility this form of ownership imposes upon the servicer.

For real estate such as a house, a shopping mall, or a condominium, the borrower owns real property (evidenced by a deed) and promises to repay a loan (evidenced by a note) and pledges to the lender security for that promise in the form of a mortgage or deed of trust. The mortgage, which is filed with an appropriate recording officer (like a county clerk), retains priority over all later interests with the exception of real estate taxes and certain super liens.

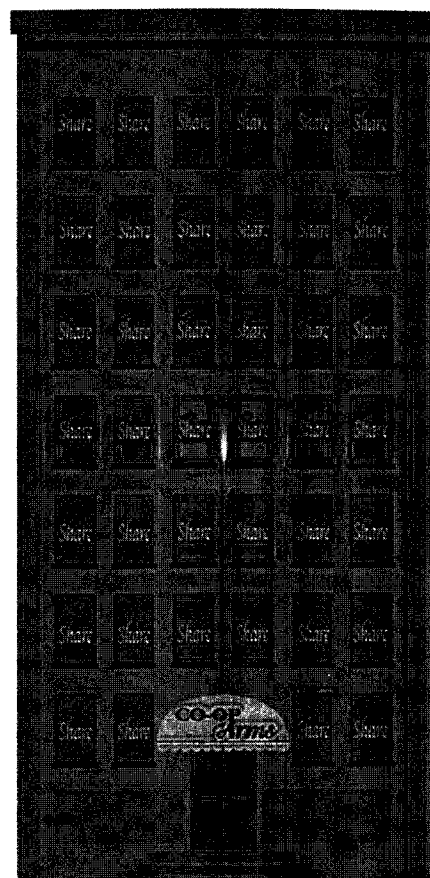
But the overwhelming basic difference is that a co-op isn't real estate; it is *personal property*. In a nutshell, a co-op corporation owns a building. By virtue of owning shares in the corporation, shareholders are entitled to a proprietary lease on units in the structure. What that person owns then are shares and a lease — in other words, personalty. If the person borrows

money to "buy" the unit (which in a co-op doesn't really happen), the pledged security consists of the shares of stock and the proprietary lease. All this is encompassed by a security agreement, not a mortgage. And to demonstrate that interest to the world, a UCC financing statement is filed — also not a mortgage.

What does the Borrower Get?

Instead of a deed, the borrower gets a lease and is thereby a "tenant" of a unit, not an owner. Pursuant to that lease the borrower — called a proprietary lessee by the co-op — must pay monthly maintenance charges to the co-op for building expenses, which would include real estate taxes on the building and installments for the underlying building mortgage. Default by the borrower on maintenance payments to the co-op becomes a very serious matter. In essence the co-op, which holds a senior position, can

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cancel the lease and take or have the shares sold — all of which extinguishes the lender's security agreement. This would be the equivalent of wiping out a lender's mortgage when a senior mortgagee forecloses.

The promise to pay can be in a note, but it is often combined with the security agreement. As mentioned, there is no mortgage (because there is no real estate to pledge as security), so the security agreement is the rough equivalent — the pledging of a security interest in personal property which in turn are the shares in the corporation and the interest in the lease.

Protecting Servicer Interest

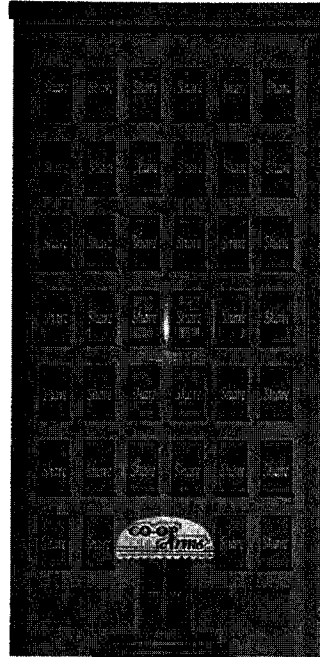
In order to gain a position of priority, the lender should obtain and file a UCC-1. That places the world on notice of the lender's prior claim to the shares and lease so that another lender cannot try to assert seniority for another loan.

Although real estate is, of course, incapable of being moved or removed, personal property can be. The borrower can physically give the shares and lease to someone else as purported security. Consequently, the lender should take actual possession of the shares and the lease. If there will ever be a foreclosure sale, the bidder — be it the lender or a third party — needs to become the owner of the shares and the lease. This is accomplished via assignment. Since the ultimate owner of this personalty is unknown, the lender requires an assignment of the shares in blank (meaning the assignee's name is not filled in), as well as an assignment in blank of the lease.

In sum, the servicer's file should contain (and copies should be forwarded to counsel when there is a default) the following documents. Those marked with an asterisk will need to be originals for an ultimate closing.

- Security Agreement
- Certificate of shares in the co-op corporation*
- Assignment of shares signed in blank by the borrower*
- Proprietary lease
- Assignment of proprietary lease signed by the borrower in blank*
- Filed UCC-1
- Co-op recognition agreement

The co-op recognition agreement is perhaps the most perplexing. Understand that the co-op has virtually unassailable authority over its units and its shareholders. As noted, monthly maintenance charges are assessed to the lessee/borrower and for failure to pay, the co-op can take the shares and lease away, thereby extinguishing not only the borrower's lease and share ownership, but the lender's security interest as well. To protect itself, the lender must have the recognition agreement signed by the co-op so the co-op is obliged to give notice to the lender of any maintenance default affording the lender or servicer an opportunity to pay the sums and protect its interest. Addition-



ally, because the co-op has essentially complete power to reject any purchaser of the co-op unit when sold, the recognition agreement binds the co-op to accept the lender as a purchaser at a foreclosure sale or for the equivalent of a deed-in-lieu of foreclosure.

More peril lurks. Because there is typically a mortgage on the co-op building, a default on the underlying mortgage can lead to the security interests on each of the units being wiped out. How lenders and servicers for the various units are to obtain protection for this

eventuality is a continuing mystery. Yet even this briefest of recitations exposes the likely breadth of issues relating to co-op servicing. Having a basic familiarity with this form of ownership should help. ■

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