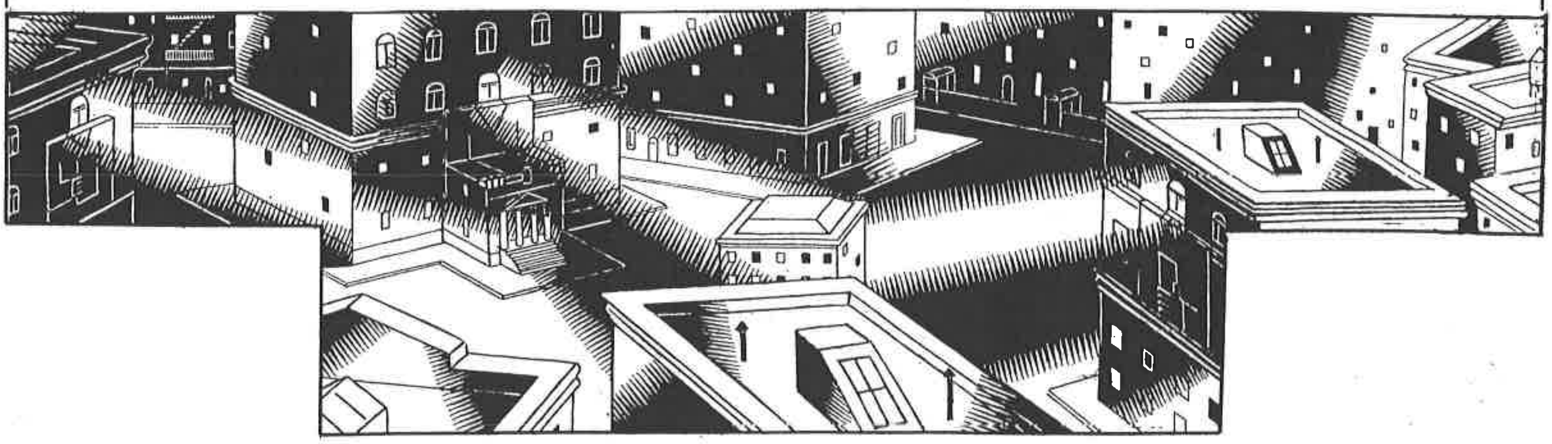
NEW YORK, WEDNESDAY, JULY 27, 1994

REAL ESTATE UPDATE



A Cooperative Loan Default

Pursuing a Mortgage Foreclosure Strikingly Unlike any Other

IN THE REALM of mortgage foreclosure, pursuing a defaulting co-op loan is in an apparently narrower world of its own. For those who encounter co-op unit defaults (in contrast to default on the underlying mortgage on a co-op building) this is a realm strikingly unlike traditional mortgage foreclosure. And if strangeness breeds the same contempt as familiarity, the distaste has been exacerbated since 1987 as co-ops plummeted in value even more precipitously than real estate.

The last thing a lender needs is a special complication or an unusual headache, such as when the borrower, otherwise current on the loan, defaults on maintenance charges to the co-op. To understand that mess — and its newly decided solution[1] — a very quick primer on co-op background and foreclosure should be helpful.

Unlike a condominium, or a house for example, a co-op unit is not real estate. It has indices of real estate and is treated similarly for a number of purposes,[2] but in the end there is no question that a co-op for the pursuit of foreclosure is personal property. So, the owner of a co-op does not receive a deed. Instead, shares of stock in the co-op corporation that owns the building are issued, and it is ownership of those shares that permits issuance of a proprietary lease.

MORTGAGE FORECLOSURES

BY BRUCE J. BERGMAN

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The borrower thus has the shares and the lease to pledge as security for the loan. The lender does not receive a mortgage (although it is often imprecisely said he does), but rather a security agreement, the actual shares (with an assignment of the shares signed in blank by the borrower) and an assignment of the proprietary lease. Because these vital papers (the stock and the lease) are pledged to the lender, the co-op itself must recognize what is in essence interference with the co-op's authority. This is accomplished by the well-known recognition agreement.

Promise to Allow Cure

In short, the recognition agreement is the co-op's assent to the pledge of security and the promise to allow the lender to cure default in any obligations the unit owner might owe to the co-op. It is here that the issues become sticky, to be reviewed further on.

Shifting to a default the borrower might commit as to the lender (typically failure to pay), the remedy can be referred to as foreclosure, although most often that is a misnomer. To be sure, a lender could actually go through the steps of a judicial foreclosure just as if an actual mortgage was being foreclosed. The pleadings are slightly different from those in a real estate mortgage foreclosure, but that is not a matter to concern us here. Such a procedure, though, is only infrequently used in New York, arising from the unfortunate duration of a judicial foreclosure case. In other words, if there is a faster method to foreclose on a co-op, why not use it?

Because personal property is at issue, the lender's remedy is controlled by the Uniform Commercial Code. The UCC provides two choices to the secured party. Absolutely the easiest is to simply send a notice to the borrower (called a debtor) that the lender (referred to as the secured party) proposes to retain the collateral (the stock and the lease) in satisfaction of the obligation. In other words, the lender says, we are going to keep the shares and the lease for the debt. If the borrower fails to object in writing within 21 days, the lender is free to keep the collateral.[3]

Perhaps because the noted method is so effortless, it is not so often employed. It is just as easy for the borrower to send the objecting letter, in which event the lender just lost at least three weeks' time — and probably more. Then there is the problem of the co-op's perception. It cannot require a lender to pursue a judicial foreclosure, but it sometimes becomes timorous in recognizing the lender as the new owner of the shares when nothing even approaching tactile formality has occurred.

All this leads to the usual method of co-op foreclosure, which is an auction sale of the security. The balance due needs to be accelerated in the standard fashion, and the sale then must proceed in a manner referred to as "commercially reasonable."[4] Without analyzing that somewhat equivocal concept in any depth, advertising for an appropriate number of times in a medium designed to disseminate news of the sale sufficiently to potential purchasers is what is required. The sale can be held in the office of the plaintiff or of its counsel or, typically, where foreclosure sales are normally conducted.

A problem more disconcerting than procedure occurs when a borrower fails to pay the required maintenance to the co-op. That, of course, is the monthly charge, which is the first cousin of a condominium common charge. Under the recognition agreement mentioned earlier, the co-op must eventually give notice to the lender that there has been this default in paying maintenance, affording the opportunity to the lender to cure that default in the borrower's behalf.

The quandary is that if the lender fails to cure, pursuant to the recognition agreement the co-op can evict the borrower/owner and then either lease the premises or sell them. The zeal of the co-op, however, to obtain the best sum to satisfy the loan is likely to be considerably less then that of the lender. Since a lender would virtually never want control of the sale to be shifted to the co-op, it must invariably cure any default in maintenance payments when the borrower has declined to make good on them.

The real nub of the dilemma arises when the borrower has refrained from paying the maintenance to the co-op on the claimed ground that some obligation owed by the co-op to the borrower has been breached — for example, that repairs were not made. If the lender advances the money to the co-op, it is likely to face the argument from the borrower that the payment should not have been made. The borrower vigorously avers that he would have prevailed in the action against the co-op, demonstrating, supposedly, that the co-op was at fault and the repair would perforce have been forthcoming. What is the lender to do to protect its position?

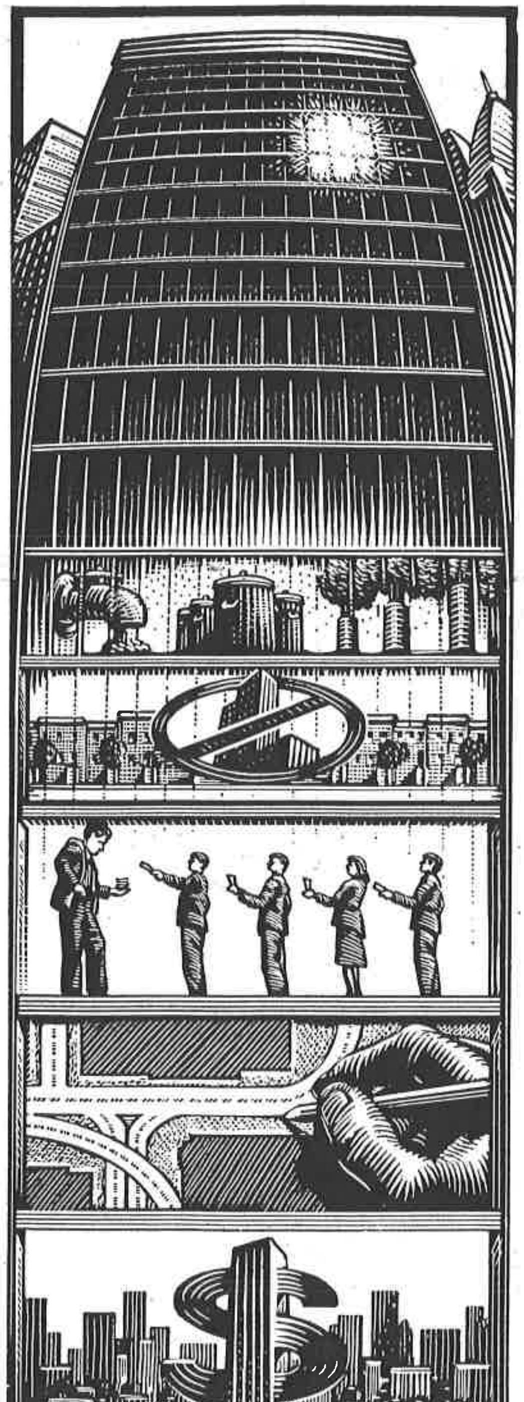

ILLUSTRATION BY JOHN MacDONALD

Although the answer appears logical and obvious, it had never quite been said before a recent case in New York County[5] finally faced the point. Some $29,000 in back maintenance was due and, under threat that the lease would be terminated, the lender understandably paid that amount to the co-op. Although the borrower was current on the loan obligation, the failure to pay maintenance was a default, and so the lender noticed a sale under the usual UCC method.

The borrower then instituted a plenary action against the lender, alleging that the apartment had suffered water damage as the result of a leak, proferring that event as the reason maintenance payments were not made to the co-op. The argument was that the co-op breached the lease and that the lender improperly or unnecessarily paid money to the co-op because the sums were not due and owing. The borrower sought to stay the lender from foreclosing until the underlying dispute with the co-op could be adjudicated.

Fortunately — from the lender's point of view — the court ruled in its favor. The recognition agreement clearly gave the lender the right to pay the maintenance and, because the apartment was the security for the loan, the lender had a critical interest in preventing the lease from being canceled and the stock sold. The court went on to rule that the dispute between the borrower and the co-op was not the lender's concern and under the terms of the recognition agreement the lender was not obligated to place its security in peril. Nor was the lender obliged to become involved in litigation about that. After all, the court said, the borrower could have avoided losing his apartment simply by paying the maintenance arrears, and he should have done so, later litigating the matter with the co-op, and never involving the lender in the issue.[6]

Although the result of this case was perhaps expected — or should have been — one cannot predict the outcome when the courts have not previously addressed the issue. This comfort in a sometimes uncertain arena is most welcome.

(1) *Israel v. Merrill Lynch Credit Corp., New York Law Journal,* Jan. 19, 1994, p. 22, col. 3 (Sup. Ct., N.Y. Co., Schackman, J.).

(2) The particularly ephemeral nature of a co-op depending upon the focus of the evaluation is well summarized in a recent case, *Baranello v. 700 Shore Road Waters Edge Inc.,* ___ Misc2d ___, 607 NYS2d 584 (1993).

(3) UCC §9-505.

(4) For some discussion of the concept see *Trust Co. of New Jersey v. Karasick, NYLJ,* Feb. 25, 1994, p. 27, col. 2 (Sup. Ct., N.Y. Co., Cahn, J.); *McCormack v. Anchor Sav. Bank,* 181 AD2d 580, 582 NYS2d 6 (1st Dept. 1922); *Transamerica Commercial Finance Corp. v. Roy A. Metthews of Scotia Inc.,* 178 AD2d 691, 576 NYS2d 939 (3d Dept. 1991); *Gannet Co. v. Tesler,* 177 AD2d 353, 577 NYS2d 248 (1st Dept. 1991); *Marine Midland Bank v. CMR Industries Inc.,* 159 AD2d 94, 559 NYS2d 892 (2d Dept. 1990).

(5) The new case is *Israel v. Merrill Lynch Credit Corp., NYLJ,* Jan. 19, 1994, at 22, col. 3 (Sup. Ct., N.Y. Co., Schackman, J.)

(6) Id.