Housing

Facing Co-Op Bankruptcy

Ana Gonzalez Ribeiro, 11.11.09, 12:04 PM EST

Co-op investors can be penalized for other people's actions. Learn about the most common types of co-op default.

The last thing those living in co-ops want to hear at their annual shareholders meeting is that their co-op is in danger of defaulting. But for many people, this is a reality. Every year, co-ops are going bankrupt and leaving their "owners" in the cold.

What Is a Co-op?
Co-ops are housing arrangements where residents own a share of the legal entity, called a corporation. These shareholders receive a proprietary lease, or right, that allows them to live in one of the apartments or units. Technically, the owner only owns shares in this corporation, not the real estate itself. The corporation owns the real estate. The owner of the shares pays a monthly maintenance cost which is used to cover building management expenses such as cleaning, heat, water, employee salaries, garbage removal, repair costs, taxes, insurance, and the building's underlying mortgage. (For a primer on mortgages, refer to our Mortgage Basics Tutorial .)

Types of Default
There are two commonly-known types of default that involve co-ops: mortgage defaults and technical defaults.

1. *Technical defaults* are not terribly serious. Adam Leitman Bailey, Esq., a New York and New Jersey real estate lawyer and head of the New York City residential and commercial real estate firm Adam Leitman Bailey, P.C., says this type of default "consists of the failure to make repairs in violation of the mortgage agreement even though all monetary payments have been paid on time." Usually, these types of defaults can be solved by arranging for the repairs to be completed, or, at least, paid for.

2. *Mortgage defaults* are much more serious, because the lender is not receiving payments for the building, as per the original agreement. This is a frustrating situation for shareholders who have diligently paid the monthly maintenance without missing payments. This is often the fastest route towards filing bankruptcy for co-ops. In this situation, the lender sends a Notice of Default to the building's management, and if the mortgage default is not resolved, the foreclosure process begins.

Worst Case Scenario: Foreclosure
Foreclosure is the worst thing that can happen when a co-op files for bankruptcy. A foreclosure is a lawsuit started by the lender to obtain legal title to the building. Stuart M. Saft, a Partner at Dewey & LeBoeuf LLP, says that in New York a foreclosure can take several years but, in the end, unless the co-

op has legitimate defense, a referee will hold an auction to sell the building, and the shareholders will revert back to being rental tenants and no longer "own" their apartments.

In the event that a co-op files for bankruptcy as a result of defaulting on its mortgage, the lender has the power to foreclose on the building and evict the shareholders. Bailey adds that, "The lender of the underlying mortgage cannot go after each apartment shareholder because the building's mortgage is not a personal guarantee by shareholders." In a bankruptcy, the co-op's bank will get paid before the shareholders.

So, any proceeds from the foreclosure sale of a bankruptcy will go to pay the bank. Shareholders who have obtained personal mortgages will be responsible for those payments even if they've lost ownership of the apartment shares.

In this scenario, shareholders don't have many options. If the co-op chooses to file a Chapter 11 (a reorganization), the co-op mortgagee can move to convert it to a Chapter 7, which is liquidation where the building is sold immediately.

In a bankruptcy or foreclosure, the co-op shareholders remain as tenants if they are living there, but their proprietary lease is canceled. If they owe any mortgage on their apartment and don't pay, "they may have adverse income tax consequences," Saft confirms. (Learn more about the differences between a Chapter 11 and Chapter 7 bankruptcy in this *FAQ*.)

Co-operatives that may be in trouble of defaulting can try and catch up with payments by borrowing additional funds, raising the monthly maintenance or adding an assessment. An assessment is a temporary increase in the monthly maintenance. This increase is designated for repairs or other expenses the co-op needs covered.

Are Co-op Bankruptcies Common?

Co-op bankruptcies are a rare occurrence, Saft says; "As far as we know, less than 10 co-ops have been foreclosed in NYC since World War II, so it is unlikely to occur now. However, it pays to be vigilant." A technical default could lead to bankruptcy if all monies in the note become due as a result of a technical default, but this is unlikely.

What Can Shareholders Do?

Unfortunately for shareholders, there is not much that can be done if they've already purchased the co-op apartment. If they have purchased shares in a troubled co-op, they should seek advice from a qualified lawyer for guidance. The key is to make educated decisions when shopping around and investigate the co-op before buying.

Bailey says that when he represents a purchaser, he makes sure the building is stable by analyzing the building's financials for the last two years. He compares the financial statement with any major structural improvements or needed repairs, and looks for whether the building has solid cash reserves. Buildings that cannot afford to make mortgage payments or meet expenses are definite red flags.

Co-op apartment hunters can avoid falling into a "bad" co-op by asking for the financials themselves. Looking over a two-year history can provide a good glimpse of how well (or poorly) the building is doing. A low cash reserve, for example, could indicate the co-op will not have enough funds to cover emergency repairs. In this case, the co-op would need to acquire the funds from either the bank in the form of another loan, or from shareholders.

Shareholders need to ask key questions when researching an apartment. For example, ask if the co-op has been making monthly mortgage payments. If they have missed payments, ask why. Ask if there are any other types of debt pending other than the mortgage, also if there are any upcoming major repairs and if so, how is the co-op planning to pay for them.

Saft suggests some tips: "Look at the last financial statement to see if the accountant issued a clean audit letter; have your lawyer see if there are any liens filed against the building or the real estate taxes have not been paid. Try to find out from the managing agent if many shareholders are failing to pay their maintenance. Have your lawyer read the co-op's minutes to see if there are any problems."

Conclusion
The co-op board has a right to ask you, as a prospective buyer, about your financial history. It wants to make sure you will be able to meet the responsibility of a monthly maintenance, in addition to your own personal mortgage payment. However, as a buyer you also have the right to make sure the living space you will end up in is economically stable. Make sure you ask about every detail. It's your future, so exercise your rights.

For additional reading, check out *Is a Housing Co-op Right For You?* and *To Rent or Buy? There's More To It Than Money*.