For Board Members and Property Managers of Co-ops and Condos™
HABITAT

Co-Opification

With the economy on a downswing, more and more condos are finding it's safer to be cooperative.

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In those rosy days of New York's late, great real estate boom, condominiums replaced cooperatives as the most desirable apartments to own. There were fewer restrictions on subleasing and selling, the thinking went, fewer hoops to jump through to satisfy nosy co-op boards. You didn't have to put as much money down, and a condo dweller would then own a physical piece of real estate rather than a piece of paper in a corporation. Condos, to top it off, were said to be worth more.

Today, thanks to the woozy economy, a spate of legal rulings, and a subtle shift in psychology, there's a dawning realization that co-op restrictions aren't always bad and condo freedoms aren't always good. As a result, many condos are adopting the very sort of rules and procedures that once made co-ops seem less desirable.

With apologies to the Queen's English, we'll call this trend the "co-opification" of New York condos. "Condos are beginning to act a lot like co-ops," says Steven Ganfer, a partner in the law firm Ganfer & Shore. "For example, condo buildings are imposing transfer fees, which are looking more and more like a flip tax in a co-op. Some condos are requiring interviews with potential buyers before they decide if they want to waive the right of first refusal."

He's referring to a condo board's right to buy an apartment at the price a potential buyer is offering, a right that is rarely exercised. Even so, more and more condo boards are asking not only for interviews but for extensive financial information from potential buyers, including tax returns, bank statements, pay stubs, and letters from current landlords and employers. Some conduct credit checks. Some even conduct criminal background checks.

Many condo boards are setting stricter rules, too, particularly on sublets. Some now require a minimum rental period (usually no less than one year); some decree that no more than 25 percent of the units can be leased at one time; some charge application and supervisory fees for major alteration projects; others, as Ganfer notes, have instituted a "transfer fee" on apartment sales (commonly referred to as a "flip tax") as a tool for replenishing the building's reserve fund.

"The condominium's position is usually that it is not using the board review process and tighter rules to limit sales," attorney Eric Gonchar wrote last fall in the in-house newsletter at his law firm, Kane Kessler. "Rather, it is using these procedures to maintain the image of the building and have more control over the quality of people who reside in the building."

Gonchar, a New York native who has been practicing real estate law in the city for more than 20 years, says the co-opification trend began building three or four years ago, when the city's real estate market was becoming critically overheated.

"The trend might be psychological," says Gonchar, who lives in a cond-op and serves as treasurer of its board. "Quite frankly, I think a lot of it is ego. Suddenly, people wanted to have control of their building; they wanted the best people and nothing less. This may just be a monster created by the inflated economy and inflated real estate prices."

Though the economy and real estate values have deflated drastically in recent months, this "monster" looks like it's here to stay.

The Courts Weigh In

One simple reason why so many condo boards have begun acting like ones at co-ops is because the courts have allowed it. In New York City, condos are governed by the antediluvian Condominium Act of 1964, the oldest in the country, which spelled out the powers of condo boards. But recent court rulings – two in particular – greatly expanded some of those powers.

The first, in 1990's Levandusky v. One Fifth Avenue Apartment Corp., stated that as long as a board acted in good faith and within its authority, its decisions could not be invalidated by the courts. The ruling applied to both co-op and condo boards. The second case, Demchick v. 90 East End Avenue of 2005, stated that a condo board could have virtually any powers the unit-owners chose to grant it, provided the powers were spelled out in the bylaws.

Not everyone is thrilled that condo boards now have the power and, increasingly, the inclination to act like co-op boards. One dissenter is Paul Fryd, a man who wears two hats. He has been a practicing attorney for 30 years and he also serves as property manager for a handful of co-ops and condos. A condo owner himself, he is less than enthusiastic about the "co-opification" trend.

"The only thing a condo board has a legitimate interest in is the deal itself – whether or not I can pay my common charges every month," says Fryd. "But in fact many condo boards ask for complete financial details, interviews, and referral letters, same as a co-op. I don't like restrictions on sales and sublets, or the intrusive nature of a co-op board."

Fryd is not alone with such reservations, and it helps explain why the vast majority of buyers have preferred condos over co-ops for the past decade or so. Despite these reservations, a growing number of condo boards are using existing powers or amending their bylaws in ways that make them look more and more like co-op boards.

The sources of every condo board's power are the Condominium Act and the building's bylaws. Changing the bylaws is always cumbersome and sometimes risky. Gerry Fifer, a lawyer who serves as president of her condo board on the Upper West Side, offers a word of caution.

"From a practical standpoint, there are good reasons for a condo to become more like a co-op," she says. "It gives you more control over who lives in the building and what they can do." But boards need to be careful when amending their bylaws because, she says, "you can get into trouble with owners who claim you're improperly restricting their use of their property." In legalese, this is called "restraint on alienation."

In Fifer's condo, the board has undertaken the cumbersome process of modifying the bylaws just once, back in 2002, when a super-majority (at least two-thirds of unit-owners) voted to change board terms from three years to two. It was not exactly a hot-button issue.

Now the board is considering two amendments to the bylaws that have the potential to become very hot-button issues, instituting a sublease fee and a flip tax. If passed by a super-majority, the two fees would give the building a distinctly co-op-like flavor. They would also give the building something Fifer considers far more important than flavor.

“Such fees give the board more money,” she says. “Condo loans are much more expensive than co-op loans, and very few banks give them. There are pros and cons to acting more like a co-op. When somebody in a condo building’s giving you trouble, you might wish you were more like a co-op because you would have the power to evict them. Condos don’t have that power.”

Financial Fundamental

Debate is sure to continue but so far, it generally hasn’t taken into account the elephant in the living room – namely, the fundamental difference between the financial underpinnings of co-ops and condos. This is something most people ignored before the economy headed south late last year. Now it’s something you neglect at your peril.

Simply put, co-ops are in a far more desirable position than condos during an economic downturn. That’s because, in the event of a foreclosure, a co-op gets its equity share before the bank can collects. To make matters worse, if a condo owner defaults on common charges but keeps paying the mortgage, the building must pursue the foreclosure – a slow, complicated, and costly process. – with no easy conclusion.

Before the current economic downturn, this difference got little notice. But suddenly, as job layoffs sweep the city like a brushfire, people are starting to take notice. With more people falling behind on their maintenance payments, both in co-ops and condos, the filing of liens is rising. Liens, which prevent title transfers until debts are satisfied, are the first step in foreclosure proceedings.

During the second half of 2008, according to the online research company PropertyShark.com, condo lien filings more than doubled in Brooklyn and rose slightly, from 342 to 357, in Manhattan. While the numbers are still relatively small, they can be likened to a falling barometer before a storm hits, a harbinger of coming foreclosures.

To prepare for – and possibly avert – a legal storm, some condo boards are moving more aggressively to collect when owners fall behind on their monthly maintenance payments. The St. Tropez on the Upper East Side, the oldest condominium in the city, recently tightened a long-standing policy of leniency on arrears. Now, when a unit-owner falls behind by 45 days, the board has its lawyer, Adam Leitman Bailey, send a letter. After 90 days, Bailey files a lien. So far, the pre-emptive strikes have worked.

“We’re noticing that when we send out liens, people tend to pay up,” says Bailey, who represents more than 80 co-op and condo boards in the city. “They just needed a wake-up call. Most homeowners will beg, borrow and steal to save their homes.”

In the past year, Bailey says, his firm has seen a ten-fold increase in lien filings, but very few foreclosures. He believes lien filings will continue to rise. “I think as the economy worsens,” he says, “we’re going to see more people not paying common charges.”

Which, in a curious twist, makes co-opification look like a pretty smart move. About four years ago, long before the boom went bust, Bailey began advising his condo boards to act like co-op boards when vetting potential buyers.

“It’s not about being picky,” he insists, “it’s about protecting the building. The condo boards want to make sure they don’t get into a situation where buyers can’t afford to pay their common charges in down times. You want to make sure people have assets beyond their job.”

With so many people suddenly out of a job, “co-opification” has begun to sound more prescient than paranoid. It has begun to sound like an idea whose time, unfortunately, has come.

Marc Held, for one, believes that’s the case. While serving as vice president of his Upper East Side condo’s board, Held, himself a real estate lawyer, suggested that a credit check be part of the vetting process for potential apartment buyers.

“Usually history repeats itself,” Held explains, “and an intelligent board examines things like credit reports. When an applicant had low credit scores, the board took aggressive action to protect the building. We collected two years of common charges at the closing before waiving our right of first refusal.”

And sure enough, history repeated itself. “That unit-owner is four or five months behind on his common charges today, and our lawyer has filed a lien,” Held says. “If we hadn’t protected the building, it would have been financially harmed.”

Like his fellow attorney Bailey, Held believes there was no snobbery at work here. “This was done because we want people to pay their bills when they’re supposed to pay their bills,” Held says. “It wasn’t done for egos. And it wasn’t done because we wanted only multi-millionaires in the building.”

In short, it was done because the condo realized it made more sense to act like a co-op.

A Tale of Two Condos

Two very different condos in two very different parts of the city have taken two very different approaches to this issue of vetting potential buyers.

The Endymion Condominium is a venerable 120-year-old building in Harlem that was gut-renovated in the late 1980s and converted soon afterward into 41 condo apartments. Since it’s a stable building with very little turnover, the board was intent on making sure that future buyers could live up to their financial obligations. But when the property manager, Sandra Greer Real Estate, proposed that the condo board act, in effect, like a co-op board, some board members were taken aback.

“We got this humongous package from our managing agent for potential buyers,” says Cheryl Delbridge, a doctor who serves as the board’s treasurer. “It asked for information on their finances – bank statements, W-2 forms, character references from their employer. They also had to sign off on the house rules and the by-laws. I was surprised but in a good way.”

When an apartment went on the market two years ago, the “humongous” package was put to use. And it worked. “Prior to that,” says Delbridge, “anyone who could make a down payment could buy an apartment. We had no way of knowing if they could afford the common charges, or if they’d read the house rules and governing documents. This provides a level of comfort and confidence. It worked out fine. The bottom line is that we know who’s coming in.”

After a nightmarish experience with a unit-owner, the Shore View Condominiums at Rockaway Beach took steps – far less drastic than the Endymion’s – to make sure that in the future they know who’s coming in.

When this three-year-old, 20-unit building started collecting maintenance charges two years ago, one owner made a few of his $315 monthly payments – then mysteriously, maddeningly stopped paying. Today, he's in arrears for more than $6,000, plus attorney's fees.

The board took the case to small claims court and has frozen one of the balky owner's bank accounts while it searches for others. While fighting this legal battle, the board is taking steps to make sure it doesn't happen again.

"What we've decided we want to do is have a streamlined application for buyers," says board president Janie Simmons, who works as a medical researcher. "At closing, the management company will require that the buyer fills out a form – phone numbers, where they work, where their bank accounts are. That way, if they stop paying maintenance, it'll be easier to find their money and, if necessary, attach their wages."

The board balked at adopting an elaborate application form like the Endymion's.

"Our management company gave us a very involved form," Simmons says, "but we didn't want to do that. We don't want to do exactly what co-ops do. We don't want only rich people here because we have a tremendously diverse community."

Simmons is also enough of a realist to realize that no safeguards, however elaborate, are fail-safe. "In this economy," she says, "the fact that someone has money and assets today doesn't mean that you're protecting yourself forever. That's a myth."