

TAKING IT PERSONALTY:

The history, structure and related characteristics of the cooperative

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INTRODUCTION

In the day and age of the condominium development, the typical practitioner may rarely encounter a client who wishes to buy or sell an apartment in a cooperative building. When a "co-op" transaction does arise, however, an attorney will want to know how to protect the client's interests. This article will describe the origin and nature of cooperative ownership, compare a cooperative to a condominium, and discuss the availability of title insurance in co-op transactions.

Ownership of a condominium unit is a real property interest — the "sticks" in the "bundle" of real property rights.¹ Ownership in a cooperative, by contrast, is a personal property interest. One entity, usually a land trust or corporation, owns the fee simple title to the land underlying the cooperative apartment building (hereinafter referred to as the "cooperative" or "co-op") while the cooperative members hold a personal property interest in the title-holding entity (percentage ownership of the beneficial interest or shares of corporate stock), accompanied by the right of possession of a particular cooperative apartment (hereinafter referred to as the "apartment") through a proprietary lease. Ownership of the beneficial interest or stock may not be separated from the possessory interest. Thus, the typical co-op transaction involves a lease (assignment of an existing lease or creation of a new lease) and a sale of shares (of beneficial interest or of stock).

CO-OP BACKGROUND

Co-ops first came into being early in the twentieth century in large urban areas as a way for wealthy urbanites to both own their apartments and, through exclusivity provisions in the corporate structure, to assure that their neighbors would be of similar wealth and social standing. A business corporation was formed to acquire and hold

title to the real estate; stock and long term proprietary leases were issued to the members; control of management was placed with the board of directors; and assessments were imposed on the members to provide income for building maintenance, repairs, mortgage payments, and real estate tax payments. During the Great Depression, many cooperatives around the nation failed. A single mortgage blanketed the entire property, and the members lost their units when other members were unable to pay the assessments needed to cover the mortgage payments. Then, in the 1960's and 1970's, promoters suggested that lower income groups could form cooperatives in order to pool their resources and afford the ownership of their own homes. Again, the same problems persisted as neighbors were unable to pay assessments and entire buildings were lost.² Co-ops exist both on Park Avenue in Manhattan and on the Northwest side of Chicago. While the motives may have been different, the structure is the same. As time passed, lawmakers created the condominium as a way to solve some of the problems of cooperative ownership.

CO-OP STRUCTURE

In modern co-ops, the fee title to the real estate may be held by a land trustee or a not-for-profit corporation. In the case of a land trust, the beneficiary may either be a corporation or the co-op members themselves (the former structure appears to be inefficient as the corporation could hold title directly). The co-op members own the beneficial interests in proportion to the approximate value of their respective units. As the beneficial interest is assigned in a purchase, either a new lease is executed to the buyer from the land trustee or the seller assigns the existing lease. When a corporation owns the co-op property, it has all of the documentary attributes of any other corporation, including charter, by-laws, stock certificates, etc. These documents, along with the proprietary

leases and possibly an operating agreement, constitute the defining characteristics of the cooperative entity and the relationships among the stockholder/neighbors.

THE CO-OP VS. THE CONDOMINIUM

Compare the cooperative apartment to the condominium unit. The condominium development, as the structure is defined by Illinois Condominium Property Law,³ is created by the plat and declaration of condominium ownership. The plat defines where the unit is located, while the declaration outlines the rights and duties of the owners and the board of managers. In the cooperative, the location of the apartment is defined by a simple designation on the lease between the corporation and the shareholder. For example, the lease may indicate that Apartment 3E is the apartment being leased and the space may or may not be referenced in the by-laws of the corporation. This Apartment 3E may simply follow an historical definition of who has lived there before and which areas they have utilized: porch, hallway, storage areas and the apartment itself. Query how wise this structure is when property interests are at stake.

Compare also the duties of the owner and board of managers. In the cooperative, the apartment owner is really only a shareholder of a corporation or a beneficiary of a land trust. Thus, the benefits and burdens of ownership are delineated by the by-laws, in the case of a corporation in title, or of a separate agreement, in the case of a land trust, or as part of the lease itself if one exists (some land trust co-ops have no leases at all). Consider, for example, a sudden need to collect special assessments for a necessary expenditure. The Illinois Condominium statute allows the board of managers to impose a lien on a condominium unit for the non-payment of assessments. Compare this with the relatively cumbersome cooperative structure whereby the governing corporation must rely on the remedies of a landlord and, in the case of a forced sale, may have greater difficulty procuring the deficiency because apartments are less marketable than condominium units.⁴

Other important distinctions exist as well between the structure of a cooperative and a condominium. Real estate taxes encumber property, and delinquent taxes can be sold and the property lost. In the condominium, after the tax division has occurred soon after the formation of the condominium, an individual unit owner has the responsibility for paying taxes as they arise on that unit alone and, if left unpaid, that individual unit can be lost at a tax sale and subsequent tax deed proceeding. Taxes on the cooperative apartment, on the other hand, are paid

by the corporation in a single tax bill covering every apartment. Usually, these taxes are collected from members as part of a monthly assessment and then paid over to the County collector. Any failure to pay even a portion of these taxes, resulting from negligence or malfeasance by the corporation's board of directors or from lack of funds when numerous members fail to pay their assessments, could result in loss of every apartment in the entire building.⁵

The foregoing discussion is not intended to suggest that all cooperatives are destined for failure. Indeed, with a tight structure and lease agreement, many cooperatives in all income brackets exist and thrive. The key seems to be preventing the foreclosure of an underlying mortgage. Two solutions exist. The first, albeit simple, is to pay off the mortgage on the underlying property. Many older ventures have done this, and then, as individual apartments are bought and sold, the prospective owners are much more secure in their lease; a potential purchase money lender is better protected should it have to foreclose on the leasehold interest. The second solution is to structure the by-laws and lease with sound provisions in case of non-payment of monthly assessments. As previously discussed, the default on a mortgage on the underlying property could mean the loss of all of the apartments. The board of directors of the corporation will need the power to quickly and efficiently remove a defaulting member from possession and sell the member's shares in order to continue the mortgage payment schedule. Since there is no ready market for co-op shares, the best strategy may be to admit only creditworthy individuals to membership in the first place; a typical by-law provision states that the board of directors must consent (or waive its right of refusal) before co-op shares and a leasehold interest may be transferred. A credit check is run on the potential member and only upon credit approval may the sale be consummated.

TITLE INSURANCE FOR CO-OP TRANSACTIONS

Buyers of cooperative apartments should always think about title insurance as an important way to protect their interests. Title insurance protection, however, will only relate to a co-op member's leasehold interest. A leasehold estate is exposed to several risks. A judgment or lien can attach to a leasehold interest, and the lienholder may foreclose on that lien at any time. Moreover, unpaid taxes on the building or a foreclosure of the blanket mortgage may result in a loss of the leasehold interest. Finally, the title company, when insuring an assignment of the leasehold interest, insures that the apartment seller does have good "title" to his or her leasehold interest (the apartment

owner may have previously assigned the lease to another who may challenge possession in the future). For all of these reasons, a leasehold owner's policy covering a co-op apartment should be insisted on for the buyer.

Certainly any lender in a cooperative transaction will require a leasehold mortgage policy. In such a policy, however, an underlying mortgage will remain as an exception to title on Schedule B and will take priority over the lien of the insured mortgage. Thus, because the apartment lender may be taking a "second" mortgage, it must be satisfied that the first mortgage on the entire building will not go into default because the assessments should cover that monthly mortgage payment.

The leasehold policy will insure a particularly described apartment located on the property in the underlying legal description on Schedule A. Remember, though, that this leasehold policy, unlike a condominium policy, is not insuring the exact size or location of the unit. On Schedule B the insured will find all matters which affect its interest and any matters which affect the underlying land or the "common areas." Would a mechanic's lien or other lien on another apartment appear on Schedule B? Probably not, because the lienor would have a lien on that other leasehold interest rather than on the insured leasehold or on the underlying fee; if, however, the work was contracted for by the board of directors or if a lien arose against the corporation in title to the co-op, the lien will appear on Schedule B.

As title clearance, a title company will ask for 1) a copy of the current executed lease (to ascertain chain of title); 2) a copy of the corporate by-laws and any changes thereto; 3) a written statement by the board of directors consenting to the assignment of lease and transfer of stock; 4) a waiver of the right of first refusal; and 5) a statement that all assessments have been paid. The attorney will notice that the requirements are strikingly similar to those required of a condominium transfer.

In order for the title insurance policy to issue, the lease and any leasehold mortgage must be recorded to satisfy the title company's concern regarding notice to third parties. Provisions in the lease prohibiting recordation of the lease are unenforceable.⁶ Provisions in corporate by-laws prohibiting recordation of leases and leasehold mortgages may, however, be enforceable. An ALTA statement will be signed, a financing statement under the Uniform Commercial Code may be recorded (to perfect a lender's security interest in the borrower's shares of stock), and full extended coverage will be given only with a survey

of the entire cooperative and a statement by the fee owner regarding the existence of possible mechanic's liens. Finally, transfer taxes must be purchased when co-op transfers are taxable under municipal, county or state transfer tax laws. For example, Chicago and Cook County stamps must be purchased and should be attached to the lease, if recorded, or may be bought and attached to the stock certificate and kept with the board of directors.

CONCLUSION

At the core of the sale or mortgage of a cooperative lies a personal property interest. Historically, title insurers have insured only real property interests. Even though co-ops are few and far between, the need for some type of protection for prospective apartment buyers and purchase money lenders prompted title insurers to adapt leasehold policies to insure possessory interests. The co-op shares are sold and proprietary leases executed, and then the owner is in possession to an apartment pursuant to the description in the lease. Because the interest is possessory, problems exist with regard to mortgages on the underlying cooperative and individual apartment, but a prudent attorney will protect his or her client by purchasing a title policy to insure that the lease or mortgage will not lose the priority expected.

FOOTNOTES

¹As John Cribbet, professor and former dean of the University of Illinois College of Law, coined the phrase.

²The Cooperative Apartment, Illinois Real Property Practice II, IICLE 1969

³See 765 ILCS 605/1 et seq.

⁴The most important aspect of marketability in real estate is the ability to sell the property for the greatest amount in the shortest period of time; an apartment buyer must meet strict income and credit requirements, may need a great deal of upfront money in order to purchase the shares of stock, and must pay relatively high assessments, all of which serve to reduce the marketability of the apartment.

⁵Even though a single entity is paying the taxes, the apartment lessee may claim a real estate exemption (homestead, senior citizen, etc.) which will, in turn, reduce the assessment needed to pay for his or her share of the taxes. See 35 ILCS 200/15-175.

⁶See 765 ILCS 5/28 which was amended to include this prohibition.