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Financing Condominiums and Cooperatives

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FINANCING CONDOMINIUMS AND COOPERATIVES

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I. CONDOMINIUMS AND COOPERATIVES—AN OVERVIEW

This article will deal with legal problems relating to the financing of condominiums and cooperatives. While space does not permit a detailed treatment of the non-financing aspects of these forms of ownership, a rudimentary overview of the legal relationships involved will preface discussion of the central topic.[1]

Both condominiums and cooperatives are legal formats for "unit ownership"—that is, the ownership of a physically defined portion of a larger parcel of (usually improved) real property. In the majority of cases, the "unit" is a residential apartment in a multifamily housing project. Condominiums are much more tightly controlled by state legislation than are cooperatives, and in recent years many states have

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1. The most complete and useful treatment of such non-financing areas is P. ROHAN & M. RESKIN, CONDOMINIUM LAW & PRACTICE (1976). Other works include D. CLURMAN & E. HEBARD, CONDOMINIUMS AND COOPERATIVES (1969); A. FERRER & K. STECHER, LAW OF CONDOMINIUM (1967); P. ROHAN & M. RESKIN, COOPERATIVE HOUSING LAW AND PRACTICE (1975); and K. ROMNEY, CONDOMINIUM DEVELOPMENT GUIDE (1974). An excellent current summary is found in *Symposium on the Law of Condominiums*, 48 ST. JOHN'S L. REV. 677 (1974).

amended their condominium statutes to permit the creation of condominiums in non-residential property, including commercial and industrial buildings, and even on unimproved land.[2] There are no significant legal barriers to non-residential cooperative ownership, although it is quite rare.

In most cases the owner of a condominium or cooperative unit is also a participant in some organization of owners which has responsibility for the operation, maintenance, and management of the "common areas"—features of the building or project which are used or available for use by all unit owners, such as lobbies, stairwells, elevators, grounds and landscaping, and often recreational facilities. The principal distinctions between condominiums and cooperatives are discussed below.

The Condominium

The term "condominium" is variously used to refer to the underlying concept, the building, or the individual unit; in this article, it refers to the building. In a condominium, each owner holds fee simple title to his unit directly. In addition, he and his fellow unit owners each own undivided fractional shares in the common areas of the project as tenants in common. Management and maintenance of these common facilities are performed by an owners' association, which may be incorporated or unincorporated.[3] The fractional shares in the common areas and the vote of each member of the association are assigned on some equitable basis, such as the number of square feet in the unit or its proportionate cost of the original construction.[4] The association

2. The model act on which many early American statutes were based used the term "apartment", presumably implying residential use; *see* FEDERAL HOUSING ADMINISTRATION, MODEL STATUTE FOR THE CREATION OF APARTMENT OWNERSHIP § 2(a), *reprinted in* G. NELSON & D. WHITMAN, REAL ESTATE FINANCE AND DEVELOPMENT 781 (1976) [hereinafter cited as FHA MODEL ACT]. Examples of much broader definitions which permit non-residential uses include ALASKA STAT. § 34.07.450(1) (1962); OKLA. STAT. tit. 60, § 503(b) (Supp. 1976); VA. CODE § 55-79.2(a) (1950). *See* P. ROHAN & M. RESKIN, CONDOMINIUM LAW AND PRACTICE § 5.01[2] (1976). On non-residential condominiums, *see generally* D. CLURMAN, THE BUSINESS CONDOMINIUM (1973); Goldstein, Lipson, Rohan & Shapiro, *Commercial and Industrial Condominiums: An Overall Analysis*, 48 ST. JOHN'S L. REV. 817 (1974); Shapiro, *Commercial Condominiums: Significant Tax Benefits Possible If Properly Structured*, 41 J. TAXATION 46 (1974); Shapiro, *Commercial Condominiums: Tax Considerations For Unit Purchasers And The Association*, 41 J. TAXATION 204 (1974).

3. The present trend seems to be incorporation of associations. *See* Hyatt, *Condominium and Home Owner Associations: Formation and Development*, 24 Emory L.J. 977 (1975); Jackson, *Why You Should Incorporate a Homeowners Association*, 3 REAL EST. L.J. 311 (1975); Krasnowiecki, *Townhouses with Homes Association: A New Perspective*, 123 U. PA. L. REV. 711 (1975).

4. *See* Reichman, *Residential Private Governments: An Introductory Survey*, 43 U. CHI. L. REV. 253 (1976).

may assert a lien on each unit to enforce the owner's obligation to pay his share of the assessments levied by the association for management, maintenance, insurance, reserves for replacements, and the like.[5]

There is little question that a form of unit ownership similar to the condominium concept can be developed by careful structuring of documents in the absence of an authorizing statute. This has been done in many countries and continues today in England.[6] However, every jurisdiction in the United States has enacted a condominium statute which attempts to regularize procedures, spell out the duties and obligations of the unit owners and the association, provide for such eventualities as damage, destruction, and condemnation of the condominium, and provide legal confirmation of the association's lien rights against delinquent unit owners. The statutes also provide for separate property tax assessment on each unit and prohibit partitioning of the common areas. Most American statutes were enacted during the 1960-1970 period, and were based heavily on model legislation drafted by the Federal Housing Administration.[7] The statutes were helpful in standardizing relationships and protecting unit owners from some forms of overreaching, but they were unnecessarily restrictive in many respects and a "second generation" of statutes, which generally provide far greater flexibility in the legal structuring of the development, as well as more extensive consumer protection, has begun to be enacted.[8]

The Cooperative

In a cooperative the entire project, including the individual units and the common areas, is owned by a single corporation (often organized as a not-for-profit)[9]. Persons who purchase units in the coopera-

5. *See* Jackson, *Homeowners Associations: Remedies to Enforce Assessment Collections*, 51 L.A.B.J. 423 (1976); Anthony v. Brea Glenbrook Club, 58 Cal. App. 3d 506, 130 Cal. Rptr. 32 (1976) (planned unit development).

6. *See* 1 P. ROHAN & M. RESKIN, CONDOMINIUM LAW AND PRACTICE, ch. 4 (1976); Leyser, *The Ownership of Flats—A Comparative Study*, 7 INT'L & COMP. L.Q. 31 (1958).

7. *See* note 2 *supra*.

8. Leaders in this movement include FLA. STAT. ANN. §§ 718.101-.508 (Supp. 1977), discussed in Comment, 8 U. MICH. J.L. REF. 387 (1975) and 27 U. MIAMI L. REV. 451 (1973); UTAH CODE ANN. §§ 57-8-1 through 57-8-36 (1953 & Supp. 1977); VA. CODE §§ 55-79.39-.103 (Supp. 1977), discussed in Comment, 9 U. RICHMOND L. REV. 135 (1974) and Johnakin, *A Second Generation of Condominium Statutes*, LAWYERS TITLE NEWS, May-June 1974, at 3. *See generally* Cannella, *Recent Innovations in State Condominium Legislation*, 48 ST. JOHN'S L. REV. 994 (1974).

9. Although corporate ownership of cooperatives is by far the most common format, trust or tenancy-in-common ownership are also possible and have been used occa-

tive receive, as evidence of their interests, two documents: a "proprietary lease", indicating the member's right of possession in the particular apartment, and a stock certificate, evidencing ownership of a share or shares in the corporation. The documents usually provide that ownership of the stock and the tenant's interest in the proprietary lease are inseparable.

In most cooperatives, each apartment owner has a single vote, rather than a vote apportioned by value or size as with condominiums. The functions of the corporation are similar to those of the owners' association in a condominium, but are more extensive. Since the cooperative corporation owns the project, it will normally be the mortgagor on one or more blanket mortgages covering the building. The "rent" paid by tenants under their proprietary leases must be sufficient to cover the cost of servicing this debt and the property taxes on the project in addition to such management, maintenance, and other expenses and reserves as would be expected in a condominium. Both condominium[10] and cooperative unit owners are entitled to deduct the portion of their monthly payments attributable to mortgage interest and real estate taxes, although this privilege is available to cooperative members only if at least 80% of the gross income of the corporation is derived from payments by tenant-stockholders.[11]

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sionally. P. ROHAN & M. RESKIN, COOPERATIVE HOUSING LAW AND PRACTICE § 201 (1975). I.R.C. § 216(b)(1)(c), which permits deduction of mortgage interest and property taxes by cooperative owners, is satisfied only if "no stockholder . . . is entitled to receive any distribution not out of earnings and profits of the corporation except on a complete or partial liquidation of the corporation." *See* the description of Co-op City by the Court in United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 840 (1975).

10. Rev. Rul. 64-31, 1964-1 C.B. 300.

11. *See* I.R.C. § 216, which imposes numerous other requirements on co-ops in addition to the 80% test. The treatment of the portion of a co-op member's monthly payment which is attributable to amortization on the blanket mortgage raises difficult tax problems. Often the co-op and its members will agree that this amount is to be treated as additional contribution to capital, and hence not income to the corporation; this is attractive, since the corporation is a taxable entity, and may otherwise owe federal tax on its income. This approach has been successful in avoiding tax at the corporate level in several cases; *see, e.g.*, Lake Forest, Inc. v. Commissioner, 22 T.C.M. 156 (CCH) (1963). However, the members may also wish to assert that the amortization component of each monthly payment *is* income for purposes of the 80% rule, thus maximizing the amount of income the co-op can receive from outside sources (*e.g.*, commercial rental space, vending and laundry machines) while still qualifying under § 216. The Court of Claims has held that the co-op and its members can agree to either capital or income treatment of the amortization payments but cannot have it both ways; *see* Eckstein v. U.S., 452 F.2d 1036 (Ct. Cl. 1971). *See* Miller, *Tax Problems of the Housing Cooperative under the 80% Income Rule*, 18 PRAC. LAW. 81 (No. 4, Apr. 1972), which also discusses the other requirements which § 216 imposes on the legal structure of co-ops.

For federal tax purposes a cooperative member is treated much like the owner of a condominium or a detached house, assuming the

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A radically different approach was used by the Tax Court in Park Place, Inc. v. Commissioner, 57 T.C. 767 (1972), which held that mortgage amortization, property tax, maintenance, and apparently mortgage interest components of payments made by co-op members to the corporation are not taxable income to it—and that the corporation has no offsetting deduction when it pays out these items—despite the fact that the same items *are* income for purposes of the 80% rule of § 216. The Tax Court thus gave the members the best of both worlds; whether this view will prevail over *Eckstein* remains to be seen.

This issue may become somewhat less important as a result of an amendment to I.R.C. § 216(c), made by § 2101(b) of the Tax Reform Act of 1976, which expressly authorizes cooperatives to claim depreciation deductions on their real estate; the Tax Court had rejected such a claim in *Park Place*. Apparently this deduction is available even if individual tenant-shareholders are also claiming depreciation on their own units because they are being used in a trade or business or for the production of income. At least in the early years of ownership of new buildings, depreciation will usually more than offset mortgage amortization, thus minimizing or eliminating taxable income even if the amortization payments are regarded as income. For older and long-held buildings, the conflict between *Eckstein* and *Park Place* will still require resolution.

Condominiums have no 80% test to meet, and they normally make no assessments upon members for mortgage interest or amortization. However, both cooperatives and condominium associations may collect general operating reserves or reserves for future replacements or improvements in amounts exceeding the offsetting deductions of the current year's expenditures. Several theories have been developed (and accepted by the Commissioner) under which these reserves may escape taxation at the association or corporate level; one such theory is that, if earmarked specifically for replacements or improvements rather than general operations or repairs, they are contributions to capital; another is that the association is merely an agent of the members in holding these funds until they need to be expended. *See* Concord Village, Inc. v. Commissioner, 65 T.C. 142 (1975); Rev. Rul. 75-370, 1975-2 C.B. 25; Rev. Rul. 75-371, 1975-2 C.B. 52; Frank, *IRS Takes Harsh Position on Exempting Condominium and Homeowners' Associations*, 44 J. TAXATION 306 (1976).

It may also be possible for a condominium or cooperative corporation to qualify for tax-exempt status under I.R.C. § 501(c)(4) as a "civic league." However, in Rev. Rul. 74-99, 1974-1 C.B. 131, the Commissioner seems to have limited application of § 501(c)(4) to associations which (1) bear a reasonably recognizable relationship to an area recognizable as a governmental subdivision or a district thereof; (2) perform no exterior maintenance on privately-owned residences; and (3) own and maintain only facilities which are used and enjoyed by the general public, such as streets and parks. Obviously, many associations far exceed these limited activities, and hence will not be deemed tax-exempt.

I.R.C. § 528, added by § 2101 of the TAX REFORM ACT of 1976, allows homeowners associations in condominiums and planned unit developments to elect a limited form of tax-exempt status. Cooperatives are not eligible for this election, and a variety of limiting criteria must be met. Moreover, if the election is made, only "exempt function income", defined as membership dues, fees, and assessments, is exempt. Income from use charges for facilities, such as swimming pools, and from other sources is taxable, and the corporate surtax exemption is denied to electing associations. Thus the election could be quite disadvantageous in some cases, and non-electing associations will presumably be relegated to the pre-1976 arguments discussed above if they wish to shelter their excess income from taxation. *See* Cowan, *Working With New Rules for Condominiums, Cooperatives, and Homeowners Associations*, 46 J. TAXATION 204 (1977).

requirements of I.R.C. section 216 are met. But for many other purposes the question remains: Is the cooperator's interest real or personal property? Since the cooperative is a unique kind of hybrid, answers to this question vary, depending on the view the courts take of the underlying policies. The characterization of the interest may be relevant for a wide variety of reasons, including the doctrine of restraints on alienation, rent control, ad valorem taxes, transfer taxes, conveyancing doctrines, construction of wills and of intestacy and judgment lien statutes, availability of title insurance, institutional financing,[12] summary eviction proceedings to members, and determination of the proper procedures for registering or recording transfers and creations of security interests, whether under the Uniform Commercial Code or realty recording acts. The answers of the courts in these contexts are far from uniform,[13] although there is no reason why the interest of a cooperative member should not be treated on a par with a condominium unit owner—as the owner of real propety—for most purposes.

It is apparent that each member of a cooperative is somewhat more reliant upon the financial strength and honesty of his or her fellow members than is a condominium unit owner. If many members of a cooperative default, it may be impossible to meet the regular debt service payments on the blanket mortgage, which may consequently be foreclosed. In a condominium, by contrast, each unit owner arranges his own permanent financing on his apartment, and defaults by one's neighbors in the payment of monthly assessments, while possibly endangering the solvency of the owners' association, cannot directly trigger foreclosure by a lender of the unit belonging to a non-delinquent owner. On the other hand, it is probably easier for the member's organization to evict a delinquent owner and to realize on the security of his unit for unpaid assessments in a cooperative than in a condominium.[14]

12. Whether cooperative financing involves real or personal property under the rules of financial regulatory agencies, and the procedures for perfecting liens on cooperative members' interests, are discussed in the text accompanying notes 111 through 118.

13. *See* Comment, *Legal Characterization of the Individual's Interest in a Cooperative Apartment: Realty or Personalty*, 73 COLUM. L. REV. 250 (1973); P. ROHAN & M. RESKIN, COOPERATIVE HOUSING LAW AND PRACTICE, § 2.01[5] (1975).

14. The cooperative can treat the delinquent member as a tenant and use unlawful detainer or other summary process to evict him; Sun Terrace Manor v. Municipal Court, 33 Cal. App. 3d 739, 108 Cal. Rptr. 307 (1973); Green v. Greenbelt Homes, Inc., 232 Md. 496, 194 A.2d 273 (1963). *See* Rohan, *Cooperative Housing: An Appraisal of Residential Controls and Enforcement Procedures*, 18 STAN. L. REV. 1323 (1966), questioning whether such a severe remedy should be available for minor defaults or violations of the co-op's rules. In a condominium, by contrast, the usual

Condominiums and cooperatives share many of the same economic and social advantages: economies of scale in the initial cost and maintenance of recreation, parking, and other community facilities, the potential for competent management of the common areas, and the advantages of security and social contact which result from relatively high-density occupancy, as well as the concomitant problems.[15] Since the advent of condominium statutes in most American jurisdictions, lending institutions and developers (and consequently consumers) have tended to prefer condominiums in most jurisdictions, and relatively few new cooperatives are being built.

II. FINANCING CONDOMINIUMS AND COOPERATIVES

Condominium and cooperative financing differ from one another in important respects. A condominium project is much like a subdivision of detached houses; financing of construction is usually independent of the permanent or long-term financing of the sales of individual units.[16] The construction loan is typically secured by a blanket mortgage on the entire property, with provision for the release of each individual unit from that mortgage as the units are sold by the developer to customers; the "partial release clause" in the construction mortgage will spell out the circumstances under which units will be released and the amount which must be applied toward retirement of the construction indebtedness for each unit sold.[17] The permanent mortgages

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remedy is foreclosure of the association's lien on the unit, an action which normally enjoys no calendar preference and may take many months to complete. In either case, of course, the association must follow its own rules and bylaws, and may also be subject to local statutes or ordinances; *see* Clydesdale, Inc. v. Wegener, 372 A.2d 1013 (D.C. 1977).

15. *See* Comment, *Community Living Condominium Style: Bed of Roses—Or Bed of Thorns?*, 6 UNIV. W.L.A.L. REV. 121 (1974).

16. *See* Pfeiler, *Condominium Financing: Some Legal Basics*, 38 U.S. LEAGUE OF SAVING A. LEGAL BULL. 249, 255-62 (1972) [hereinafter cited as Pfeiler]. Like most subdivision lenders, the condominium construction lender will usually require that a "take-out" or permanent loan commitment be obtained from another lender (or the permanent loan department of the same institution) before approving the construction loan. *See* Fegan, *Condominium Financing*, 48 ST. JOHN'S L. REV. 799 (1974) [hereinafter cited as Fegan].

17. A common provision requires "pre-sales" (executed contracts of sale to customers) on some fixed percentage of the units (say, 35% to 75%) before the construction lender will release the lien on any of the units. *See* Vishny, *Financing the Condominium*, 1970 ILL. L.F. 181 (1970). Similarly, the permanent lender may refuse to disburse funds until a specified percentage of the units have been presold; Fegan, *supra* note 16. The Federal Housing Administration generally requires that 80% (in value) of the units be presold before unit titles can be transferred and FHA mortgage insurance issued; *see* 24 C.F.R. § 234.26(c)(3) (1977).

In imposing such requirements, lenders are concerned that they not be committed

placed on individual units by their purchasers are usually arranged by the developer through a single lender, which may or may not be the mortgagee on the construction loan.[18] In theory unit purchasers can obtain long-term loans from institutions which have had no prior contact with the project, but this is much more difficult than in subdivisions of detached houses; many lenders will be reluctant to undertake an extensive review of the documents which relate to a condominium if they expect to make only one or a few loans on units in that project.[19]

Cooperatives are also financed with construction mortgages, but there are generally no individual loans to those who purchase the units when construction is completed.[20] Instead, the construction loan may simply be converted to a permanent loan by the mortgagee—which means that it will begin to draw regular (usually monthly) payments of amortization and interest. At that point the construction loan may also be sold by the original mortgagee to another investor, particularly if the construction lender is a type of institution that prefers to avoid long-term mortgages. Alternatively, the cooperative corporation may obtain a new blanket loan from a permanent lender and use the proceeds to discharge the construction loan. In either event, the permanent mortgage on a cooperative project is a blanket mortgage covering the entire property. Unit purchasers make down payments equal to the difference between the unit's market sales value and its pro-rata share of the blanket mortgage; in effect, they assume their shares of the mortgage.

The subsequent resale of an individual unit by one occupant to another also involves different treatment in condominiums than in co-

to financing the project as a condominium until they have substantial evidence of consumer demand; if the demand does not materialize, they may insist that the building be converted to rental use.

18. As an alternative to financing unit sales with new permanent mortgages, it is theoretically possible for the construction lender to take a separate mortgage on each unit, and to convert those mortgages to permanent status by loan assumptions as the units are sold to customers. This procedure is fairly common in some areas of the nation with subdivision development, but is not widely used with condominiums. It arguably violates § 14 of the FHA MODEL ACT, *supra* note 2, which provides: "At the time of the first conveyance of each apartment, every mortgage and other lien affecting such apartment . . . shall be paid and satisfied of record . . . ." There is no policy reason to prohibit assumptions of construction loans by unit purchasers, and the Model Act should not be so construed.

19. Such loans are sometimes termed "spot mortgages", and many lenders avoid them; their reluctance makes it extremely difficult for the original permanent lender to diversify its portfolio by declining to make resale financing available as the units turn over later. *See* Gose, Strum & Zinman, *Real Estate Financing Techniques: What Now?*, 9 REAL PROP., PROB. & TRUST J. 617, 634 (1974).

20. Berger, *Condominium: Shelter on a Statutory Foundation*, 63 COLUM. L. REV. 987 (1963).

operatives. In a condominium unit sale the existing mortgage may be assumed, taken subject to, or paid off by the unit purchaser with the proceeds of a new loan he has arranged, just as in the sale of a detached house. By contrast, the sale of a cooperative unit amounts to an implicit "assumption" by the purchaser of that unit's pro rata share of the blanket mortgage on the project. Hence the cash paid by the purchaser of a resale cooperative unit may represent three components: (1) the amortization of the blanket mortgage which has occurred since payments were commenced on it; (2) the original unit purchaser's downpayment; and (3) any increase in value which may have occurred since the project was completed due to inflation or to improvements.[21]

Obviously, the longer the project is occupied the higher the cash required by a resale purchaser is likely to be, and the greater the difficulty the seller can anticipate in finding a buyer with sufficient cash and a willingness to invest it in the unit. The seller may be willing to take a promissory note from the purchaser in lieu of some part of this cash, and may be able to secure such a note with an interest in some real or personal property belonging to the purchaser. But an installment sale by the unit owner may jeopardize the standing of the purchaser under I.R.C. section 216.[22]

Additional problems arise if the installment seller desires a security interest in the unit. Under one approach, the purchaser may pledge

21. Some cooperatives limit the resale price by bylaw to the original down payment made by the seller, and others allow him to recoup only his improvements, his share of the mortgage amortization achieved, and some cost-of-living adjustment factor. *See* FHA Model Form of Bylaws § 8(d), *reproduced in* J. KRASNOWEICKI, HOUSING AND URBAN DEVELOPMENT 317, 323 (1969); NATIONAL COMM'N. ON URBAN PROBLEMS, BUILDING THE AMERICAN CITY 137 (1968). Many cooperatives impose no restrictions on resale prices at all.

22. I.R.C. § 216(b)(2) defines a "tenant-shareholder" as one "whose stock is fully paid-up in an amount" reasonably related to the unit's share of the corporation's equity in the project. The applicable regulation, Treas. Reg. § 1.216-1(e) (1977), appears to say that this relationship is to be determined "as of the date of the original issuance of the stock". Arguably, an installment sale would qualify if the purchaser made a cash payment equal to the unit's share of the original equity, but this is not clear. Alternatively, the purchaser might structure the transaction so as to "fully pay" for the *stock* with cash, but to pay some additional amount, by way of a promissory note, for the assignment of the *proprietary lease*. The difficulty with this argument is that the stock and lease are invariably required by their own terms or the applicable corporate charter or bylaws to be held by the same person. In sum, whether any installment sale can qualify under § 216 is problematic. This is unfortunate, since there seems to be no policy reason whatever to make the tax benefits of § 216 hinge on an all-cash sale. *See* Miller, *Tax Problems of the Housing Cooperative Under the 80% Income Rule*, 18 PRAC. LAWYER 81 (No. 4, Apr. 1972).

Since an installment purchaser is arguably not a "tenant-shareholder", it is entirely conceivable that a single installment sale could so reduce the total income from tenant-shareholders that the cooperative would cease to qualify under the 80% test of § 216.

his stock and assign his interest in the proprietary lease to the seller as security; this may be satisfactory, but many sellers may feel that the legal protection available from such a scheme is inferior to that which a mortgage would give them. Two barriers to the use of a conventional legal mortgage are the lack of a separate, reliable legal description of the unit, and the fact that the legal title is held by the cooperative corporation rather than the occupants of the unit. In addition, many cooperatives impose rights of first refusal or other forms of restrictions on the resale of units which might make it difficult for a secured party to realize on the security, no matter what form it takes.

It would be possible to reduce cash requirements for cooperative resale buyers if institutional lenders were willing to make "second" loans on the security of cooperative units. Any such loans would clearly be subordinate to the existing blanket first mortgage on the entire project, since there is normally no provision in such mortgages for the release of individual units from the lien's coverage. Institutional lenders could take pledges and assignments of the stock and lease on the units as security. There is no doubt that such a method is legally workable, although subject to the same uncertainties as purchase-money financing by vendors mentioned in the foregoing paragraph. Moreover, whether the regulatory agencies which supervise institutional lenders will recognize such loans as secured, rather than as mere personal loans, is doubtful in many jurisdictions.[23] These financing problems tend to be reflected in large cash requirements for entry into cooperatives, and consequently limit access to relatively high-income purchasers.

It is quite possible that the corporation might decide to refinance the original blanket mortgage on the project; this might be done because the original mortgage is of the balloon type and has reached maturity,[24] because lower interest rates have become available, or because additional cash is needed for repairs or improvements. This last objective might also be achieved by the placement of a second blanket mortgage on the property without disturbing the first. It is apparent that

23. *See* notes 108-113 *infra* and accompanying text.

24. While most buildings newly constructed for cooperative use are financed with fully-amortized mortgages, it is not unusual to find a balloon mortgage on a building which is converted from ordinary rental to co-op use. Indeed, if the interest rate on the existing mortgage is significantly below current rates at the time of conversion, it would be foolish to refinance at the time of conversion, notwithstanding the balloon feature of the old loan. *See* Offering Statement, 72-84 Barrow Street, *reprinted in* 2A P. ROHAN & M. RESKIN, COOPERATIVE HOUSING LAW AND PRACTICE, at 245, 288 app. (1975).

either refinancing or additional financing can result in higher monthly assessments on the members than they anticipated when they joined the cooperative. If an appropriate vote of the directors or members is forthcoming, the added assessments will be imposed on all members, whether they agree with the decision or not.[25] Thus, each member's financial future lies to some extent in the hands of his neighbors; a situation which some might think uncomfortable, and which is largely avoided by the condominium form of ownership.[26]

One should not assume that permanent financing is always essential to the sale of either condominiums or cooperatives. Especially in retirement developments, all-cash purchases are quite common, since many buyers have just sold larger detached houses, often at substantial gains. Retirees usually wish to reinvest these funds and find the purchase of a condominium or cooperative unit a convenient way of doing so. Moreover, federal income tax on the gain from the sale of the previous house may be avoided entirely if the new unit costs at least as much as the sales price of the house sold.[27] This benefit is available whether a condominium or a cooperative unit is purchased, and does not depend on the presence or absence of mortgage financing on the new unit.

III. CONSTRUCTION FINANCING OF CONDOMINIUMS

Although the financing of condominium construction is much like

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25. For example, the Standard Form Cooperative Bylaws published by the New York Attorney General provide, at Art. III, sec. 7:

> The Board of Directors shall have discretionary power to . . . determine the cash requirements of the Corporation to be paid as aforesaid by the shareholder-tenants under their respective proprietary leases. Every such determination by the Board of Directors shall be final and conclusive as to all shareholder-tenants . . . .

See P. ROHAN & M. RESKIN, COOPERATIVE HOUSING LAW AND PRACTICE 24.67 app. (1975). Similar language is found in most proprietary leases. The decision-making power of the Board is generally very broad, and could even extend to a resolution to sell the project and distribute the proceeds to the members. *See* Anderson, *Cooperative Apartments in Florida: A Legal Analysis*, 12 U. MIAMI L. REV. 13, 35 (1957).

26. But not completely. Even in a condominium, it is possible for the owners' association to levy larger-than-expected assessments to cover extravagant improvements to the recreational facilities or other common areas. Since title to common areas is held by the unit owners in tenancy in common, the association cannot mortgage them. Nonetheless, the assessments themselves are liens on the units, whether particular owners approve of the expenditures or not. In some cases, condominium bylaws may place an upper limit on assessment amounts.

27. I.R.C. § 1034, which permits this deferral of gain, applies whether the old or the new residence is a condominium or a cooperative; *see* I.R.C. § 1034(f); Rev. Rul. 64-31, 1964-1 C.B. 300. If a cooperative unit is purchased, the unit's proportional share of the project's mortgage indebtedness is included in the purchase price for purposes of qualifying under § 1034; *see* Rev. Rul. 60-76, 1960-1 C.B. 296.

subdivision financing, there are important differences.[28] The documentation of a condominium project is much more complex, its marketability more speculative (at least, from the perspective of many institutional lenders), and the risk of loss it presents in the event of failure correspondingly greater.

Every new condominium project begins with site selection and acquisition. Developers commonly use their own capital to pay the cost of necessary land options. Before applications for institutional financing can be made, however, other costs must be incurred; surveys, engineering and market studies, and architects' fees, for example. These may be financed by use of the developer's cash or the contributions of his business associates, or through unsecured debt. In some cases these expenses are reimbursed out of the first draw of funds on the construction loan.

Upon exercise of the land option, the developer may be expected to pay the full cash price of the land to the seller. Often, however, the seller can be persuaded to sell on an installment basis and to accept a minimal initial cash payment. This installment indebtedness will usually be secured by a mortgage, and it will be necessary for the seller to subordinate his lien to that of the construction loan,[29] since virtually all construction lenders, as a matter of policy or the requirements of their governmental regulatory agencies, insist on first priority for the construction mortgage. Unless it is to be paid off from the proceeds of the construction loan, the land seller's subordinated mortgage (like the construction mortgage) must contain a partial release clause enabling the sale of individual units free of the lien.

When the land has been optioned and the necessary background studies completed, the developer is ready to apply for a construction loan. This submission is usually more comprehensive than would be expected in a detached-house subdivision, and the developer may seek the assistance of a mortgage loan broker in preparing and presenting it to prospective construction lenders. Such lenders will be particularly interested in the developer's own financial position, prior condominium experience, and reputation; they will also analyze the market demand information, architectural and engineering work, and general demo-

28. Good general discussions of condominium construction financing include K. ROMNEY, CONDOMINIUM DEVELOPMENT GUIDE ch. 7 (1974); Fegan, *supra* note 16; Pfeiler, *supra* note 16.

29. Subordination by vendors is discussed in Note, *Purchase Money Subordination Agreements in California: An Analysis of Conditional Subordination,* 45 S. CAL. L. REV. 1109 (1972).

graphic and locational data submitted by the developer. In many cases the construction lender will make no commitment until permanent financing has been arranged for the sales of units; hence, the developer will make a similar submission of information to prospective permanent lenders, who are generally concerned with the same factors. The permanent financing commitment is not only a prerequisite to construction financing in many cases, but comprises a powerful marketing tool as well, especially if it ties the permanent lender to a fixed interest rate in a rising interest market.

A project does not become a condominium until some basic document—usually termed a master deed, declaration, or plan of unit ownership—is executed by the owners of the real estate and filed for record. This master deed describes the project, the individual units, and the common areas; it assigns weights to each unit for voting and assessment purposes; it provides for a lien on the units to secure the assessments; and it may contain such covenants as a right of first refusal upon resale by a unit owner.[30] The master deed may be filed whenever the owners desire, but in many cases the construction lender will insist that filing be delayed until some fixed percentage of the units have been "presold"—that is, until prospective unit purchasers have paid earnest money deposits and signed purchase agreements on them. On the other hand, no conveyances by deed of units can occur until the master deed has been filed.[31] Given these constraints, the filing usually occurs sometime towards the end of the construction period.

Construction loan mortgages on condominium projects can be insured by the Federal Housing Administration (FHA) under section 234(d) of the National Housing Act.[32] This insurance coverage, which is not generally available on construction loans in detached-house subdivisions, is not particularly attractive to most developers. The principal amount of the loan may be as high as 90% of the "replacement cost" of the project;[33] in substance, this means the actual cost of land and improvements.[34] By contrast, conventional construction loans are

30. Some writers have questioned whether such a clause may constitute an unreasonable restraint on alienation or may violate the Rule Against Perpetuities. Neither result seems justifiable or probable. *See* 1 (pt. 2) P. ROHAN & M. RESKIN, CONDOMINIUM LAW AND PRACTICE § 10.03 (1976). The FHA approved form of master deed does not contain a right of first refusal.

31. *See* 24 C.F.R. § 234.26(d)(1) (1977) (FHA-insured condominium mortgages).

32. 12 U.S.C. § 1715y (Supp. V 1975); applicable regulations are found at 24 C.F.R. §§ 234.1ff (1977).

33. 12 U.S.C. § 1715y(e)(2) (1970).

34. 24 C.F.R. § 234.505(h) (1977).

rarely made for more than 75% or 80% of value, but "value" as calculated by the conventional lender may be as high as the total retail sale price of the units, which will generally exceed the project's cost by a substantial margin.[35] Thus, conventional construction financing may actually be for as much or more money than FHA-insured financing. The only other significant advantage of an FHA-insured construction mortgage is that the developer is assured that FHA mortgage insurance will also be available on the permanent loans on individual units as they are sold.[36]

Unfortunately, FHA-insured construction loans have numerous disadvantages. FHA regulations impose dollar limits on the mortgage amount per unit, and effectively eliminate luxury or even high-middle-income projects.[37] The developer must enter into a regulatory agreement with FHA which may significantly limit his discretion in managing the construction and marketing of the project.[38] FHA mortgage insurance premiums must be paid in addition to interest, fees, and discounts charged by the lending institution. Moreover, FHA processing of multifamily mortgage insurance applications has the reputation of being slow and cumbersome, and FHA minimum property standards with respect to some construction features may appear excessive to some developers.

In light of these problems, it is not surprising that there has been relatively little construction lending under the section 234 program. An internal study of FHA's condominium activity has recommended major changes in the program, but they would require legislative action and have not been seriously considered by Congress at this writing.[39] Despite FHA's early influence in the promulgation of state condomin-

35. *See* K. ROMNEY, CONDOMINIUM DEVELOPMENT GUIDE § 7.04 (1974).

36. Loans on individual units in a project not previously covered by an FHA blanket mortgage are insurable by FHA only if the project contains eleven or fewer units, National Housing Act § 234(c), 12 U.S.C. § 1715y(c) (Supp. V 1975). An internal study of condominium financing by the Federal Housing Administration has criticized this requirement as unnecessarily restrictive. *See* U.S. DEP'T OF HOUSING AND URBAN DEVELOPMENT, CONDOMINIUM STUDY (1975).

37. The limits have been increased on several occasions. At this writing they range from $19,500 for a no-bedroom unit in a low-rise building to $43,758 for a unit with four or more bedrooms in an elevator building. The elevator-building limits may be increased by as much as 50% in high cost areas. 24 C.F.R. §§ 234.525-.530 (1977).

38. 24 C.F.R. § 234.26(f) (1977).

39. U.S. DEP'T OF HOUSING AND URBAN DEVELOPMENT, HUD-FHA CONDOMINIUMS: THEIR FUTURE (1975).

ium legislation, it has become a minor factor in condominium financing.[40]

Developers of condominium projects sometimes do not complete construction. Failure to do so may result from poor planning and management of the construction work, inadequate budgeting, unanticipated increases in costs, weather problems, strikes, or weak market acceptance of the project. Abandonment will invariably constitute a default under the terms of the construction loan mortgage, and the lender may elect to foreclose. In this setting there are usually unpaid workmen, subcontractors, or suppliers who are entitled to file mechanics' liens. In addition, the prospective purchasers of units in the project will have signed contracts of sale and made down payments or earnest money deposits with the developer; some such contracts may have been executed before construction began, and some afterward. These three groups, the construction lender, mechanics' lienors, and vendees often find themselves adverse to one another in respect to rights in the real estate.

Such problems are not unique to condominium developments; they also occur with speculative subdivisions and other types of construction. We discuss them here because condominiums have frequently been defaulted upon during construction in recent years, and because condominium statutes sometimes contain provisions which bear on these disputes. The problem of priorities as between construction lenders and mechanics' lien claimants will not be covered in this article.[41] Suffice it to say that, in general, the relative priority of the lender and the lien claimant will depend on the language of the mechanics' lien statute, the timing of commencement of work on the project vis-a-vis the recordation of the construction mortgage, and the question of whether the advances made by the construction lender were optional or obligatory.[42]

Priority as between construction lender and vendees

A difficult conflict may arise with respect to earnest money

40. During the first half of the 1970's, FHA blanket condominium mortgages never reached an annual rate of 10,000 units, and was only 1277 units in 1975. *See* U.S. DEP'T OF HOUSING AND URBAN DEVELOPMENT, 1975 STATISTICAL YEARBOOK 120 (1976).

41. *See generally* Note, *Construction Lending—General Contractor v. Lender*, 54 N.C.L. REV. 952 (1976).

42. *See* Kratovil & Werner, *Mortgages for Construction and the Lien Priorities Problem—the "Unobligatory" Advance*, 41 TENN. L. REV. 311 (1974).

deposits or down payments (the terms are used here synomously) collected from intended unit vendees before and during the construction period. If these funds, which may be very substantial, are available for current use by the developer, they may help him solve serious cash shortage problems, but at high risk to the vendees.[43] The FHA[44] and the statutes of a few states[45] require that such deposits be escrowed pending completion and transfer of title of the individual units, making them inaccessible to the developer. Such provisions are highly desirable. Where this is not the law, a problem arises in situations in which the developer has invaded the deposits and subsequently abandons the project prior to completion; the unit purchasers may well be left with only their personal rights of action against the developer (who is often insolvent). Even if the construction lender forecloses and completes construction, the original unit subscribers may have neither the right to complete their purchases by paying the remainder of the original contract price, nor the right to a return of their deposits.

This issue may be characterized as one of priority as between the purchase contracts and the construction mortgage. The contract vendee has, under the law of most states, an equitable lien on the realty to secure the return of his down payment if the vendor fails to complete the contract.[46] The difficulty is that the lien's enforceability is constrained in two respects: first, it may be subordinate to pre-existing liens, such as the construction mortgage, if it arises after that mortgage is recorded; and second, it is not enforceable even against a subsequent mortgagee or purchaser who has no notice of the existence of the vendee's contract.[47] The latter constraint may not be a serious problem in most cases; seldom will a construction lender grant a loan without first asking about preconstruction sales activity, and the developer

43. *See* Damian, *Condominium Development: Representing the Developer*, in CONDOMINIUM DEVELOPMENT 35, 61 (Prac. Law Inst. 1971).

44. *See* FHA Subscription and Purchase Agreement, Form No. 3279, cl. 1, *reprinted in* 1 P. ROHAN & M. RESKIN, CONDOMINIUM LAW AND PRACTICE § 9.04[6] (1976).

45. *See, e.g.*, VA. CODE § 55-79.95 (Supp. 1977); FLA. STAT. ANN. § 718.202 (Supp. 1977) (permitting the developer to use the money to defray construction costs if the contract of sale so provides). *See* Note, *Recent Innovations in State Condominium Legislation*, 48 ST. JOHN'S L. REV. 994, 999 (1974); Note, *Florida Condominiums—Developer Abuses and Security Law Implications Create a Need For a State Regulatory Agency*, 25 U. FLA. L. REV. 350, 358 (1973). The better approach is to prohibit by statute all developer use of deposit funds; the significance of contract language permitting his use of deposits is unlikely to be understood by lay purchasers.

46. Gribble v. Stearman & Kaplan, Inc., 249 Md. 289, 239 A.2d 573 (1968). *See generally* Annot., 43 A.L.R.2d 1384 (1954).

47. National Indemnity Co. v. Banks, 376 F.2d 533 (5th Cir. 1967); Mihranian, Inc. v. Padula, 134 N.J. Super. 557, 342 A.2d 523 (1975).

will ordinarily be eager to inform the lender of the contracts which have been signed.[48] The matter is more difficult if the purchase contract is signed after the construction mortage has been recorded. In *State Savings and Loan Association v. Kauaian Development Co.*,[49] the Hawaii Supreme Court drew a distinction between subscription agreements entered into before and after the creation of the construction mortgage. Agreements executed after the mortgage were obviously subordinate to it, the court thought, apparently because of the constructive notice the public records imparted to vendees, while those executed before the mortgage recordation had priority. However, the court observed that even prior subscription agreements could be made subordinate to the mortgage by express language of subordination, which could be placed in the purchase contract or in a separate document signed by the vendee. The court did not discuss the degree of specificity that would be necessary in such clauses, nor whether it would require that they be intelligible to the laymen signing them.

As a consequence of the *Kauaian* reasoning, most purchase agreements in use now probably contain subordination language;[50] a foreclosing construction lender would thus appear to be free to disregard the agreement and sell the unit to another purchaser and would have no obligation to return the deposit to the contract vendee.

However, the enforceability of such subordination clauses may be open to serious doubt. The purchaser will ordinarily be entirely unsophisticated, and is unlikely to have any concept of the significance of the clause. In addition, the clause will seldom contain details of the proposed construction financing to which the vendee is being asked to subordinate. By analogy to the cases involving so-called "automatic"

48. *See* Wayne Bldg. & Loan Co. v. Yarborough, 11 Ohio St. 2d 195, 228 N.E.2d 841 (1967); Palmer v. Crews Lumber Co., Inc., 510 P.2d 269 (Okla. 1973). These cases suggest that it is sufficient that the subsequent lender knows a contract has been executed, whether or not he is aware of the terms of the contract, the vendee's identity, or the amount of any downpayment made.

49. 50 Haw. 540, 445 P.2d 109 (1968).

50. *See, e.g.*, Olympic Towers Purchase Agreement, *reprinted in* 1A P. ROHAN & M. RESKIN, CONDOMINIUM LAW AND PRACTICE, 118.17 app. (1976):

> The Purchaser agrees that all terms and provisions of this contract are and shall be subject and subordinate to the lien of any building loan mortgage heretofore or hereafter made and any advances heretofore or hereafter made thereon and any payments or expenses already made or incurred or which hereafter may be made or incurred, pursuant to the terms thereof, or incidental thereto, or to protect the security thereof, to the full extent thereof without the execution of any further legal documents by the Purchaser. This subordination shall apply whether such advances are voluntary or involuntary and whether made in accordance with the building loan schedule.

subordination of purchase-money financing by land vendors to developers, it might well be argued that such subordinations by contract vendees are too vague or too unfair to enforce.[51]

Even a contract vendee who signed his contract after the constructiuon mortgage was recorded, or who has executed a valid subordination clause, might nonetheless manage to persuade a court of his priority. If the developer's default is traceable in part to the failure of the construction lender to monitor and supervise the progress of the project as its documents gave it the right to do, or if the lender negligently permitted the developer to divert loan funds away from the project, the vendee might argue that he is the third party beneficiary of the construction loan agreement, and that the proper remedy for the lender's breach of that agreement is a loss of priority for the construction loan.[52] Depending on the facts, an argument against the lender's priority may also be based on estoppel. If the lender has reviewed and approved the sales price schedule and the purchase agreement forms, has supplied the developer with criteria for qualifying prospective purchasers in respect to income, credit worthiness, and the like, and has mandated the pre-completion sale of some fixed number of units as a condition of the construction loan agreement, a court might well find the lender estopped by its extensive involvement in the vendor-vendee relationship to deny the priority of the vendee's lien.[53]

51. *See* Handy v. Gordon, 65 Cal. 2d 578, 422 P.2d 329, 55 Cal. Rptr. 769 (1967); Grooms v. Williams, 227 Md. 165, 175 A.2d 575 (1961). *Cf.* Starr v. Mooslin, 14 Cal. App. 3d 988, 92 Cal. Rptr. 583 (1971), holding an attorney liable for malpractice in incompetently drafting a subordination agreement.

52. *See* Planters Lumber Co. v. Wilson Co., 413 S.W.2d 55 (Ark. 1967), elevating a mechanics' lien above a construction mortgage to the extent the mortgage proceeds were not used on the project; Middlebrook-Anderson Co. v. Southwest Sav. & Loan Ass'n, 18 Cal. App. 3d 1023, 96 Cal. Rptr. 338 (1971), in which a vendor of land who held a subordinated purchase-money deed of trust had his priorities elevated above that of the construction lender on this theory; Kennedy v. Betts, 33 Md. App. 258, 364 A.2d 74 (1976); Cambridge Acceptance Corp. v. Hockstein, 102 N.J. Super. 435, 246 A.2d 138 (1968). *But see* Pope Heating & Air Cond. Co. v. Garrett-Bromfield Mortgage Co., 29 Colo. App. 169, 480 P.2d 602 (1971), holding a subordination agreement unconditional and binding despite diversion of construction loan funds; Forest Inc. v. Guaranty Mortgage Co., 534 S.W.2d 853 (Tenn. Ct. App. 1975) (*semble*); *See also* Falls Lumber Co. v. Heman, 114 Ohio App. 262, 181 N.E.2d 713 (1961), in which a construction lender was held liable in tort to a contract vendee for its failure to disburse construction funds in accordance with the applicable statute, thereby permitting mechanics' liens to be filed against the property; *cf.* Gardner Plumbing, Inc. v. Cottrill, 44 Ohio St. 2d 111, 338 N.E.2d 757 (1975).

53. *Cf.* Fikes v. First Fed. Sav. & Loan Ass'n, 533 P.2d 251 (Alaska 1975), holding a construction lender's lien limited to funds actually spent on construction and not diverted, as against the claim of a prior contract vendee of which the lender had knowledge; Tucson Fed. Sav. & Loan Ass'n v. Sundell, 106 Ariz. 137, 472 P.2d 6 (1970) (*semble*) in which the court relied on the fact that the vendee had no knowl-

An alternative approach for the vendee might be based on an analogy to the cases which have permitted subcontractors and materials suppliers to assert an equitable lien on any undisbursed portion of the construction loan funds if the usual mechanics' lien remedies are unavailing to them.[54] In equity, the contract vendee would seem to have as strong a moral claim to these funds as do those who have invested labor and materials, at least if construction has been completed without exhausting the construction loan account and the vendee's deposit has been used for construction purposes. Unfortunately, this argument may be ineffective in those jurisdictions which have codified the equitable lien concept without including contract vendees among its beneficiaries. New York, for example, has created a statutory trust consisting of the down payments of contract vendees.[55] However, they may recover their funds after the developer's default only if they have not been used in improving the property; in addition, the usual classes of mechanics' lien claimants have first priority on the trust funds.[56] This

edge of the construction mortgage. No cases have been found in which the estoppel argument has been raised by a junior vendee. The tendency of courts to protect contract vendees against the literal language of subordination clauses they have signed is illustrated by First Fed. Sav. & Loan Ass'n v. Ott, 285 So. 2d 695 (Fla. Dist. Ct. App. 1973), in which the developer refinanced the original construction loan with the same lender; the court refused to enforce the subordination agreement in vendee's contract and she was permitted to take free of the refinanced mortgage. In Security Nat'l Bank v. Village Mall at Hillcrest, 85 Misc. 2d 771, 382 N.Y.S.2d 882, 889 (Sup. Ct. 1976), the Attorney General of New York argued that the construction lender's lien should be subordinated to the liens of contract vendees because the lender had (1) modified the construction loan agreement without recording the modification, (2) participated in a public offering of the condominium project without making the required disclosures to offerees under New York law, (3) participated in a violation of the statutory provisions allowing vendees' deposits to be used only for improvements, and (4) charged usurious interest rates. The court found that triable issues of fact were involved and denied summary judgment on the merits of these claims.

54. *See* Swinerton & Walberg Co. v. Union Bank, 25 Cal. App. 3d 259, 101 Cal. Rptr. 665 (1972); J.G. Plumbing Inc. v. Coastal Mortgage Co., 329 So. 2d 393 (Fla. Dist. Ct. App. 1976); Crane Co. v. Fine, 221 So. 2d 145 (Fla. 1969). As a result of statutory change the remedy is apparently no longer available in California; *see* Boyd & Lovesee Lumber Co. v. Modular Marketing Corp., 44 Cal. App. 3d 460, 118 Cal. Rptr. 699 (1975). A similar remedy, known as the "stop notice", is available by statute in a few states, but probably could not be asserted by contract vendees. *See* Comment, *Mechanics' Liens: The "Stop Notice" Comes to Washington*, 49 WASH. L. REV. 685 (1974).

55. N.Y. LIEN LAW § 71-a (McKinney 1966).

56. *See* Security Nat'l Bank v. Village Mall at Hillcrest, Inc., 85 Misc. 2d 771, 382 N.Y.S.2d 883, 889 (Sup. Ct. 1976); Glazer v. Alison Homes Corp., 62 Misc. 2d 1017, 309 N.Y.S.2d 381 (Sup. Ct. 1970). The latter case, though sound in policy, seems to go quite beyond the statutory language and permits contract vendees to assert a lien on funds which were wrongfully diverted by the developer from construction loan proceeds, although the opinion concedes that mechanics' liens would have a superior claim to these funds.

approach seems entirely inadequate to protect the vendees, although it may be better than no protection at all.

As a matter of policy, it is entirely reasonable to impose on the construction lender a duty to return vendees' deposits in cases in which the lender had played an active role in approving or supervising the developer's marketing program. The lender is far better able than the vendee to investigate the developer's solvency, experience, and reliability, and to spread the risk of the developer's default. Moreover, any construction lender wishing to avoid this risk may easily do so merely by requiring that all deposits by vendees be placed in escrow. The law should not permit developers (and construction lenders) to rely upon vendees' down payments as a means of financing construction; doing so is an indicator that the developer is dangerously underfunded, and a lender who actively countenances such a procedure should be held accountable to the vendees for their loss.[57]

Priority as between mechanics' lien claimants and vendees

The rights of mechanics' lien claimants in condominium projects raise problems similar to, but more intricate than, those of claims made on subdivision lots. Even if the work was done or the materials supplied on only a single lot or unit, the matter is not simple. It is clear enough that if the vendee enters into his contract of purchase after the work has been completed and the lien filed of record, the lien will have priority and the vendee will take subject to it.[58] This means that if the developer (or his general contractor) are unavailable for recovery, as is all too common, the unit vendee will suffer the loss unless he is protected by an owner's policy of title insurance.

If the vendee acquires legal title by deed to the unit or lot after the work has been done and the lien has "attached",[59] but before the

57. In some respects the matter is similar to Connor v. Great Western Sav. & Loan Ass'n, 69 Cal. 2d 850, 447 P.2d 609, 73 Cal. Rptr. 369 (1969), in which a construction lender was held liable to home purchasers for its failure to adequately supervise the construction of houses with serious structural defects. Although *Connor* has not been widely followed, *see* Callaizakas v. Astor Developer Co., 4 Ill. App. 3d 163, 280 N.E.2d 512 (1972), the case of diversion of vendees' downpayments seems an especially appealing one for application of the concept, since developers' marketing programs are so generally superintended by construction lenders, particularly in condominium projects.

58. United Accounts, Inc. v. Larson, 121 N.W.2d 628 (N.D. 1963); Annot., 85 A.L.R. 927, 928 (1933).

59. The exact time at which priority attaches varies among jurisdictions. Many fix it as of the day the first work is done on the overall construction project, and others on the date the lien claimant first performed his work. Less popular rules

lien is filed of record, he may be entirely innocent of any actual knowledge of the lien's attachment. A few jurisdictions, mostly in the South, protect bona fide purchasers in this situation, granting them priority over the lien.[60] Most states, however, hold the vendee's interest subject to the lien, either on the ground that even BFP's are subject to mechanics' liens[61] or that the very fact of construction activity on the land imparts notice of the potential filing of liens, and thus negates BFP status.[62] Moreover, owner's title insurance coverage is unlikely to assist the purchaser on these facts; many policies expressly exclude coverage for unfiled liens.

Suppose the vendee's contract of purchase predates the attachment of the lien, even though the conveyance by deed occurs later. May he argue that his vendee's lien created by execution of the contract has chronological, and thus legal, priority over the mechanics' liens? In *Wayne Building & Loan Co. v. Yarborough*,[63] the Ohio Supreme Court so held, although the vendee was given priority only to the extent of down payments made before the liens attached at the commencement of the work; the vendee had no priority as to further payments he made on the contract after work began. The decision appears to place no emphasis on whether the lien claimants had notice of the executed contract of purchase at the time they began their work,

attach the lien at the time the general contract or the claimant's contract is entered into or recorded, or when the notice of lien is filed of record. Under all of these rules except the last-mentioned, a lien may attach without any clear evidence of the claim appearing in the public records. The lien must usually be "perfected" by filing of record within some fixed period after the work is completed, and is then said to "relate back" to the attachment date. *See* R. KRATOVIL, MODERN MORTGAGE LAW AND PRACTICE § 214 (1972); 4 AMERICAN LAW OF PROPERTY § 16.106F (A.J. Casner ed. 1952).

60. *See, e.g.*, KY. REV. STAT. § 376.010 (Supp. 1976); Walker v. Valley Plumbing Co., 370 S.W.2d 136 (Ky. 1963); First State Bank v. Stacey, 37 Tenn. App. 223, 261 S.W.2d 245 (1953); Wood v. Barnes, 420 S.W.2d 425 (Tex. Ct. App. 1967); Comfortcraft Heating, Inc. v. Salamone, 19 App. Div. 760, 241 N.Y.S.2d 581 (1963); Bryant v. Ellenburg, 106 Ga. 510, 127 S.E.2d 468 (1962).

61. Schrader Iron Works, Inc. v. Lee, 26 Cal. App. 3d 621, 103 Cal. Rptr. 107 (1972); State Sav. & Loan Ass'n v. Kauaian Devel. Co., 50 Haw. 540, 445 P.2d 109, 123 (1968); Metropolitan Water Co. v. Hild, 415 P.2d 970 (Okla. 1966). *See generally* G. THOMPSON, REAL PROPERTY § 5218 n.69 (1957).

62. The knowledge of work in progress may be actual or constructive. *See* Guaranty Pest Control, Inc. v. Commercial Inv. & Devel. Corp., 288 Ala. 604, 264 So. 2d 163 (1972); Capital Bank & Trust Co. v. Broussard Paint & Wallpaper Co., 198 So. 2d 204 (La. App. 1967); Clark Certified Concrete Co. v. Lindberg, 216 Md. 576, 141 A.2d 685 (1958); J.R. Meade Co. v. Forward Constr. Co., 526 S.W.2d 21 (Mo. App. 1975); H. TIFFANY, REAL PROPERTY § 1578 (1939); Annot., 50 A.L.R.3d 944 (1973).

63. 11 Ohio St. 2d 195, 228 N.E.2d 841, 849-50 (1967).

but such notice would presumably strengthen the vendee's position. Thus, in one Texas case the lien claimants were permitted priority for work done up to the time they learned of the executed contract, but not thereafter.[64] However, the existence of the purchase contract has been fatal to the vendee in several decisions in which courts have seen it as clearly establishing the vendee's position as an equitable "owner", and thus a member of the class of persons whose interests were subject to mechanic's liens.[65]

As these cases suggest, the relationship of vendees' and lien claimants' rights is uncertain and confused, although the lienors have usually prevailed. The courts have vacillated between the traditional desire to protect good faith purchasers and to enhance the reliability of the public records, on the one hand, and the wish to construe the lien statutes liberally to aid lien claimants, on the other. One major defect in the system lies in its failure to require potential lien claimants to record some public notice as a condition of *attachment* (rather than mere perfection) of the lien. But even a change in the law in this respect would not fully protect purchasers, since they rarely examine the public records or obtain title reports before signing purchase agreements and making deposits. In essence, the contest is between two claimants neither of whom has taken any formal step to give the world notice of his lien, and each of whom is at least dimly aware of the other's potential existence. On these facts it would be arbitrary to make priorities turn on which interest "attached" first, as by lien claimant's first work or the vendee's execution of a contract. Given the almost universal lack of sophisticated residential unit buyers, and the alternative methods open to lien claimants, who are generally well aware of the risks, to safeguard their interests,[66] the preferable approach to this dilemma (short of comprehensive legislative reform) is to recognize a prior vendee's lien for all deposits paid prior to the time the purchaser

64. Stone v. Pitts, 389 S.W.2d 601 (Tex. Ct. App. 1965). The lienor's knowledge of the vendee's interest may also be used to compel him to include the vendee as an "owner" in the notice of lien, and failure to do so may exculpate the vendee. *See* F.M. Sibley Lumber Co. v. Gottesman, 314 Mich. 60, 22 N.W.2d 72 (1946); *cf.* Oklahoma Hardware Co. v. Townsend, 494 P.2d 326 (Okla. 1972). *See* Annot., 48 A.L.R.3d 153 (1973).

65. Home Carpet, Inc. v. Bob Antrim Homes, Inc., 210 N.W.2d 652 (Iowa 1973); Toler v. Satterthwaite, 200 Kan. 103, 434 P.2d 814 (1967).

66. Subcontractors and materialmen may verify the developer's credit standing, may contact the construction lender to determine whether the project is on schedule and funds available, may insist on immediate payment in cash, or may confine their business activities to developers who have payment bonds. None of these steps may be completely effective or feasible, but they place the potential lien claimant in a considerably stronger position than contract vendees.

learns not merely that work has been done on the land, but that delinquent payments are owed to potential lien claimants.

Assuming that a condominium unit purchaser is subject to mechanics' liens, other questions arise. If the work was done or the materials supplied for several units, the common areas, or the entire project, what interests are subjected to the lien? Most of the courts which have dealt with the issue have held that the common areas as such are not lienable.[67] Often this result follows from express language in the condominium statutes involved; the common areas have no independent legal existence apart from the units to which they are appurtenant.[68] Hence a lien claimant who has performed work only on common areas would be expected to file the lien on the individual units—presumably all of them—whose owners had rights in the common facilities in question. A further problem for the lien claimant is raised if some of the units have been conveyed by the developer at the time he hires the lien claimant-to-be. The vendees of these units might argue that they cannot be held subject to the lien because they neither contracted for nor consented to the work done.[69] It is likely, however, that they would be held to have consented, or be estopped from denying their consent, if the work in question benefitted common areas in which they had rights and which they expected to use.

If work is performed on numerous units, the common areas, or the project as a whole, is a lien claimant required to apportion the lien among all of the affected units and satisfy it from each of them only on a pro rata basis? If the law does not compel this result, the claimant obviously has power to create great injustice among unit owners by "picking on" some while favoring others. This issue has risen fre-

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67. *See, e.g.*, Country Village Heights Condominium v. Mario Bonito Inc., 79 Misc. 2d 1088, 363 N.Y.S.2d 501 (Sup. Ct. 1975); Stevens Constr. Co. v. Draper Hall, Inc., 73 Wis. 2d 104, 242 N.W.2d 893 (1976). *But see* Plateau Supply Co. v. Bison Meadows Corp., 31 Colo. App. 205, 500 P.2d 162 (1972); E.D. McGillicuddy Constr. Co. v. Knoll Recreation Ass'n, 31 Cal. App. 3d 891, 107 Cal. Rptr. 901 (1973). The *Stevens* case concludes that liens on the common areas are impermissible even though the lien claimants commenced their work before the condominium declaration was recorded, and thus at a time when the building was not subject to the condominium statute.

68. FHA MODEL ACT § 9(a), *supra* note 2; A. FERBER & K. STECHER, LAW OF CONDOMINIUM § 117 (1967).

69. *See, e.g.*, Romito Bros. Elec. Constr. Co. v. Frank A. Flannery, Inc., 40 Ohio St. 2d 79, 320 N.E.2d 294 (1974). The New York statute permits the filing of a lien on an individual unit only if the work was requested by the owner of the unit or was for emergency repairs. *See* Country Village Heights Condominium v. Mario Bonito, Inc., 79 Misc. 2d 1088, 363 N.Y.S.2d 501 (Sup. Ct. 1975).

quently in the subdivision context, and the courts have almost uniformly held that, if the lien is susceptible of reasonable apportionment, then apportionment is required.[70] In a condominium, apportionment would seldom be difficult to calculate, since the units are even more likely to be of similar value and have similar construction than subdivision houses. Moreover, many condominium statutes expressly provide that a lien on more than one unit can be satisfied and discharged by pro rata payment by each unit owner.[71] One court has interpreted such language as applicable only when the lien is incurred by one or more individual unit owners, rather than by a developer,[72] but this construction seems strained and inequitable. Whatever the source of the lien, it should be dischargable as to any unit when its owner pays his share; this seems to be the prevalent view.

Mechanics' liens and the assessments of an owners' association may interrelate in at least two ways. It is common for the association to begin functioning and collecting assessments prior to the completion of some phases of the project. If this occurs, a contest may arise as to priority between the mechanics' liens and the association's lien for unpaid assessments. This matter may be resolved by reference to the jurisdiction's condominium statute. Many statutes provide that the assessment lien is superior to all liens except ad valorem taxes and the first mortgage on any unit.[73] However, a New York court, apparently contradicting the statutory formulation, has given priority to the mechanics' liens on the ground that the association's liens do not come into existence and acquire a priority date until some notice or action to enforce them is filed.[74]

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70. Apportionment of mechanics' liens required in Weaver v. Harland, 176 Va. 224, 10 S.E.2d 547 (1940). *See also* CAL. CIV. CODE § 3130 (West 1974); DEL. CODE tit. 25, § 2713 (1974).

71. FHA MODEL ACT, § 9(b), *supra* note 2; A. FERBER & K. STECHER, LAW OF CONDOMINIUM § 117 (1967).

72. E.D. McGillicuddy Constr. Co. v. Knoll Recreation Assoc., 31 Cal. App. 3d 891, 107 Cal. Rptr. 901 (1973); the court did not explain why allocation of the lien on a pro rated basis among unit owners was impractical. The opinion seemed to rely upon the fact that all purchasers had owner's title insurance coverage—a consideration which seems both irrelevant and improper.

73. *See* FHA MODEL ACT § 23(a), *supra* note 2; A. FERBER & K. STECHER, LAW OF CONDOMINIUM § 128 (1967). A few statutes expressly grant priority to mechanics' liens; *see* IDAHO CODE § 55-1518 (1976); N.C. GEN. STAT. § 47A-22(a) (1966); WIS. STAT. ANN. § 703.23(1)(a) (West Spec. Supp. 1977).

74. *See* Security Nat'l Bank v. Village Mall at Hillcrest, 85 Misc. 2d 771, 382 N.Y.S.2d 882, 896 (Sup. Ct. 1976); *cf.* N.Y. REAL PROP. LAW § 339-z (McKinney Supp. 1967).

The New York statute expands the rights of mechanics' lien claimants in another fashion as well, granting them, for work done on common areas, a lien on funds collected by the owner's association.[75] This remedy was apparently thought necessary because of the impermissibility of liening the common areas directly, the difficulty of proving that unit owners requested the work done on common areas, and the cumbersomeness of apportionment of the lien among a large number of individual units. From the lienor's viewpoint this remedy is probably superior to merely filing an action to collect the debt owed. In cases in which the association itself requested the work done the procedure is reasonable, but if the work was done at the developer's request, it is difficult to see the fairness of imposing on the association the duty of repaying it.

IV. FINANCING CONVERSIONS TO CONDOMINIUM AND COOPERATIVE STATUS

Rental apartment buildings are frequently converted to condominium status. The converter may be the original landlord, or the building may be sold to an intermediary who will handle the conversion and marketing process. Often some remodeling and refurbishing of the apartments, lobby, and recreational facilities is necessary. The financial rewards of the conversion can be extremely attractive, since buildings often sell for as much as 33 to 40 percent more than their previous value as rental properties.[76] For landlords who find themselves beset with rising costs for maintenance and utilities, complaints from tenants, and the growing influence of rent control ordinances, conversion may seem an ideal way out of an uncomfortable position.[77]

At the same time, conversion is a risky business.[78] Marketing of the converted apartments may be slow, especially if numerous other buildings are being converted or new condominiums built in the same market. It is usually desirable to keep the unsold units rented, but

75. N.Y. REAL PROP. LAW § 339-*l*(2) (McKinney Supp. 1967).

76. *See* Jaskol, *A Lender Looks at Condominium Conversions,* 4 REAL EST. REV. 70 (No. 1, 1974); NAT'L ASSOC. OF HOME BUILDERS, *Now Is the Time for a Good Condominium Conversion,* N.A.H.B.J.-SCOPE (June 4, 1973). On the treatment of the sale profit as capital gain or ordinary income, *see* Shapiro & Lemiech, *Tax Planning the Condominium Conversion—Analysis of Capital Gain Possibilities,* 1 J. REAL EST. TAX. 184 (1974).

77. 1 P. ROHAN & M. RESKIN, CONDOMINIUM LAW & PRACTICE § 3A.01 (1976).

78. *See* Moss, *Checklist for Successful Condominium Conversions,* 5 REAL EST. REV. 116 (No. 3, 1975).

vacancies often grow when the tenants know that the building is being converted. On the other hand, in many buildings the existing tenants cannot afford the purchase prices of the converted units, and hence are forced out of their longtime residences; they may oppose the conversion bitterly, and in some jurisdictions their opposition will constitute a legal barrier.[79] Detailed discussion of these problems is beyond the scope of the present treatment, but they must be considered carefully by any lender who is asked to finance a conversion.

Occasionally an apartment building owner is able to manage a conversion without resort to new blanket financing, but this can be accomplished only if the existing mortgage lender is agreeable. If the mortgage contains a due-on-sale clause, the lender must waive it. The lender must also be willing to join in the condominium declaration, and must modify the existing mortgage documents by inserting a partial release clause, thereby permitting the sale of individual units free of the blanket lien. Often the lender is uninterested in taking these steps, or will do so only in return for financial concessions which the converter finds unacceptable. The alternate approach for the converter is to obtain an interim loan from a different lender which will contain the necessary language, and whose proceeds will be used to pay off the existing loan. The attractiveness of this technique will depend on numerous factors, including the interest rate and other costs associated with the interim loan, and the prepayment penalty which may be demanded by the old lender.

Interim loans to finance conversions usually do not require regular principal amortization, but do require the reduction of the principal by some agreed amount for each condominium unit sold, much in the same manner as blanket construction loans on subdivisions.[80] They are usually limited to 75 or 80 percent of the property's value *as a condominium*, but if this would result in a loan approaching 100 percent of the value as a rental project, the interim lender will often require some cash investment by the converter, thus limiting the loan to, perhaps, 90 percent of the rental value. In any event, the "value" on which the loan is based will generally include the cost of the renovations which

79. *See, e.g.*, N.Y. GEN. BUS. LAW § 352-e(2) (McKinney Supp. 1976-77) (requiring approval of Attorney General and 35% of existing tenants); *Condominium Conversion Ban Extended*, Wash. Post, Oct. 16, 1974, at A1, col. 6, and numerous other articles in the same period.

80. *See* Fantini, *A Practical Primer for Analyzing Condominium Conversions*, 34 THE MORTGAGE BANKER 48 (Aug. 1973); Reppe, *Winning Over the Condominium Lender*, 5 REAL EST. REV. 104 (No. 2, 1975).

the converter plans to make. A portion of the interim loan may even be disbursed in installments as these improvements are put in place, as with a construction loan.

The interim lender is intensely concerned with the converter's cash flow projections for the conversion period. The building must generate enough cash to cover interest payments on the interim loan as well as the usual operating, maintenance, and management costs of a rental building, and the converter's obligation to pay assessments to the new owners' association. Since a shortfall can easily result in default and foreclosure of the interim mortgage, the interim lender must be confident that it can complete the conversion successfully if necessary.

Conversion of rental buildings to cooperatives is far less common nationally than conversion to condominiums, but it has been a frequent occurrence in New York. The motivations for a cooperative conversion are much the same as have been discussed above: avoidance of rent control and high costs, and the opportunity to make a substantial profit.[81] However, the financing problems are much simpler since, absent a due-on-sale clause, the agreement of the existing lender is generally unneeded, and the conversion can proceed without his participation. Often the outstanding balance on the existing financing will be too low to make conversion feasible. In such cases the existing loan may be refinanced, or if its interest rate is so low that it is worth preserving, a wrap-around second mortgage may be arranged to provide cash for refurbishing the building and to lower the required down payments of the apartment purchasers. Separate original, interim, and permanent loans are not necessarily required, however; if the original financing on the rental building is satisfactory, there is usually no reason that it cannot be carried through the conversion period and become the permanent financing for the cooperators.

V. PERMANENT FINANCING OF CONDOMINIUM UNITS

Permanent mortgage loans on condominium units can generally be made by institutional lenders on the same terms as loans on detached houses or other buildings. However, the permanent lender on a condominium unit must be concerned with many factors which are unimportant or entirely irrelevant in the financing of subdivision

81. *See* P. ROHAN & M. RESKIN, COOPERATIVE HOUSING LAW & PRACTICE § 6.02 (1975); Richards v. Kaskel, 32 N.Y.2d 524, 300 N.E.2d 388, 347 N.Y.S.2d 1 (1973).

houses.[82] Most of these factors are related to the importance of the owner's association and the common areas to the success (and thus the future security value) of the project. While the discussion which follows concentrates on the permanent lender's concerns, construction lenders should also be cognizant of the factors mentioned, since they may be forced into a permanent lending role in the event of the developer's default on the construction loan or the permanent lender's refusal to honor its loan commitment. Indeed, unit purchasers themselves should be equally mindful of these problem areas, although they are often insufficiently sophisticated to realize the potential dangers.

Certain precautions are particularly significant to the permanent lender if it finances the sale of some units while other units or the common areas are still under construction or remain in the developer's hands. Obviously, the unit being financed should itself be completed. To ensure that the project will be successfully marketed as a condominium, many permanent lenders impose a "pre-sale requirement"; that is, they will refuse to close any loans until the developer has entered into binding sale contracts for some fixed percentage of the units.[83] The permanent lender will also be legitimately concerned with the developer's financial ability to complete the project, and may wish to verify that sufficient funds remain in the construction loan account for this purpose.

The payment of assessments to the association for unsold units can also pose a problem. Many statutes make no distinction between sold and unsold units, and require that assessments be collected uniformly from all. This approach seems unreasonable from the developer's viewpoint, since unoccupied units obviously contribute little or nothing to certain variable costs of the association's operations; for example, they supply no users for the swimming pool, tennis courts, or equestrian trails. On the other hand there are many fixed costs which are independent of the number of users. A fair resolution of this problem would be to require a somewhat smaller assessment for units still owned by the developer than are paid for occupied units. While a two-level assessment system is not permitted under many statutes, the same result may be achieved if the developer pays a full assessment but is en-

82. *See generally* Jackson, *Attorneys for Lenders: What You Should Check in Condominium and PUD Documentations,* (pts. 1 & 2) 4 BARRISTER 47 (Winter), 55 (Spring) (1977) [hereinafter cited as Jackson]; Waldron, *Curtain May Soon Rise on Act Two of Condominium Problems,* 37 MORTGAGE BANKER 27 (Nov. 1976); Pfeiler, *supra* note 16.

83. *See* Vishny, *Financing the Condominium,* 1970 U. ILL. L.F. 181, 190.

titled to reimbursement of a portion from the other owners under a separate contract. Alternatively, the developer might pay the full assessment amounts and attempt to recover his outlays through higher sale prices for the later-sold units.[84] In any event, the permanent lender should ascertain that the developer is obligated to pay a fair share of the costs of operating the association during the marketing period and that he has the financial strength to do so; his default might result in deteriorating physical facilities or a financially weakened or even insolvent association. The lender might even require a cash deposit from the developer to secure these payments.

The permanent lender must also be concerned with the developer's attempts to retain control over the association until most of the units have been sold. Often this is accomplished by creating two classes of stock, attached to unsold and sold units respectively, with the former having a greater voting power. For example, if the first class has three votes per share and the second only one vote per share, the developer can maintain effective control until the project is three-fourths sold. This degree of retention of control is probably reasonable to protect the developer against the enactment of rules or procedures which would retard his sales.[85] The permanent mortgagee, however, may refuse to lend if the period of developer control will extend past the three-fourths sales mark, and may also insist on the fixing of an outside date by which control must pass to the unit owners irrespective of the number of sales.

Virtually every important aspect of the association's ongoing functions concerns the permanent lender, since operational inadequacies may be reflected in diminished security value of the units. Questions on which the lender will need to be satisfied include the following: Is membership in the association automatic? Has a lien for unpaid assessments been created by proper language in the declaration or master deed? Has the association established a reasonable budget, supported by adequate assessment amounts? Is the assessment delinquency rate reasonably low? Have adequate reserves for repairs and replacements been set up, with provision that they not be used except for specified items? Has a competent management firm been hired if the project

84. *See* Wolfe, *How to Set Up a Homeowners Association So It Works For (Not Against) You*, House & Home 74 (Sept. 1974).

85. *Id.* at 83. A few statutes expressly limit the period of developer control; *see, e.g.*, FLA. STAT. ANN. §§ 718.301 (condominiums), 719.301 (cooperatives) (Supp. 1977).

is large enough to justify it? Is the project subject to unreasonable management contracts or recreational facility leases? Is an independent annual audit made of the association's books? Has adequate blanket insurance been arranged for the common areas and exteriors of units, with provision for increased coverage to match inflation?

Many permanent lenders insist on certain types of protection in the condominium documentation. For example, the lender may want: notice from the association of default in assessments by any of its mortgagors; exemption (if the lender becomes the owner of a unit through foreclosure) from the usual clause giving the association a right of first refusal or other right to control the subsequent transfer of the unit, and from any restriction on leasing of units; notice of cancellation of any insurance policies on the project; the right to examine the association's books at reasonable times; notice of association meetings and the right to attend; notice of any substantial loss or damage to common areas; and the right to vote on, or even to veto, such major policy decisions as the hiring or firing of a management firm, amendments to the declaration or bylaws, expansion or contraction of the project, or use of hazard insurance proceeds other than for repairs.

Finally, the lender will probably wish to redraft its usual mortgage and note forms to add special provisions relating to condominiums.[86] These revisions will usually include covenants by the mortgagor to pay his association assessments when due, to notify the lender of any delinquency notices received from the association, and to abide by all provisions of the condominium's declaration, by-laws, and rules. The documents may require that assessments be paid to an escrow or impound account. The mortgagor may also be required to covenant not to vote in favor of major policy changes in the project without the mortgagee's consent. Failure of the association to maintain adequate insurance coverage may be made a condition of default, and the lender may reserve the right to pay delinquent assessments and to charge them against the mortgagor's loan balance.

Authority of lenders, insurers, and investors

There is little controversy concerning the power of lenders to

86. Pfeiler, *supra* note 16, at 261; *Condominium Rider*, FNMA/FHLMC, UNIFORM INSTRUMENT 6/75; Grosser, *Making the Loan Commitment*, in COMMUNITY ASS'N INSTITUTE, SUMMARY OF PROCEEDINGS, FIRST NAT'L CONFERENCE ON COMMUNITY ASS'NS 66 (1976).

make permanent mortgage loans on condominium units. Both federally-chartered and state-chartered institutions are generally permitted to treat them as the equivalent of single-family houses,[87] although the lending powers of state-chartered institutions are a matter of state law and some variations exist.[88]

The Federal Housing Administration (FHA) insures permanent mortgages on condominium units under the same general terms and conditions as mortgages on detached houses, but if the project has more than eleven units, insurance on permanent mortgages is available only if the project has previously been covered by an FHA-insured project mortgage.[89] Thus large numbers of projects are ineligible because they were constructed with conventional financing.

The Veterans's Administration (VA) was first given authority to guarantee loans on condominium units in 1970, but could do so only when at least one unit in the project had been insured by FHA.[90] In 1975 this statutory limitation was dropped, and the VA now guarantees such loans regardless of prior FHA involvement.[91] VA imposes a number of requirements to protect its interests,[92] including the escrowing of earnest money deposits by developers, a seventy percent presale requirement (which may be reduced to fifty-one percent in special circumstances), and limitations on reservations of rights by developers (such as the leasing of common areas to the association and the retention of a veto over the association after unit owners obtain majority control). In addition, VA regards projects as unacceptable if they prohibit leasing of units for six months or more, or impose a right of first

87. *See, e.g.*, 12 C.F.R. § 7.2195 (1977) (Ruling of the Comptroller of the Currency: condominiums treated as real estate for lending by national banks); 12 C.F.R. § 541.10 (1977) (Federal Home Loan Bank Board definition of "single-family dwelling" includes condominium units for purposes of lending by federal savings and loan associations).

88. Many state statutes dealing with institutional lending powers make no reference to condominiums, apparently relying instead on their respective condominium acts to establish that condominium units are to be treated as other dwellings. Some statutes deal specifically with loans on condominium units, and may establish somewhat different lending criteria than apply to detached houses. *See, e.g.*, CAL. FIN. CODE § 7153.1 (West Supp. 1977).

89. National Housing Act § 234(c), 12 U.S.C. § 1715y(c) (Supp. V 1977); 24 C.F.R. § 234.26(a) (1977).

90. Veterans Housing Act of 1970, § 3, 84 Stat. 1108 (current version at 38 U.S.C. § 1810(d) (1970)).

91. Veterans Housing Act of 1974, Pub. L. No. 93-569, § 3, 88 Stat. 1863 (adding 38 U.S.C. § 1810(a)(6) (Supp. V 1975) and repealing 38 U.S.C. § 1810(d) (1970)).

92. *See* Policies and Procedures, Condominium Loans Under 38 U.S.C. § 1810(A)(6), 40 Fed. Reg. 21794 (1975).

refusal upon resale.[93] As with FHA, the terms of the VA loan guarantee are identical to those on detached houses.[94]

Both the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) purchase permanent mortgage loans on condominium units. If a project has been the subject of an FHA condominium project mortgage, neither of these secondary market agencies is further concerned with the documentation; however, if construction was conventionally financed, FNMA and FHLMC impose a number of stringent requirements on the documentation and on certain operational aspects of the project as well.[95] The two agencies have similar, but not identical, requirements; they are too numerous to be summarized here, but generally deal with the issues and concerns discussed earlier in this section.[96] FNMA will not purchase condominium mortgages in excess of ninety percent of the unit's value, while FHLMC will buy ninety-five percent mortgages. The two agencies also differ in their procedures for purchase of condominium unit mortgages. FNMA must receive full information on the project and approve it before any individual unit mortgages will be purchased;[97] an essential element of the initial submission is an attorney's opinion verifying that the documents meet FNMA's criteria.[98] FHL MC, by contrast, does not give prior approvals. Instead, it requires that the originating lender submit, with the first unit loan sold to FHL MC, a certification that the documents meet FHLMC's requirements.[99] An attorney's opinion must be obtained, but may simply be retained in the lender's files.

An obvious concern to permanent lenders is the priority of the mortgage loan as against the lien of the owner's association for unpaid assessments. A large majority of the state statutes follow the FHA Model Act in providing that the lien is subordinate to any "first mort-

93. The latter requirement is imposed only on condominiums established after December 31, 1976; *see* 41 Fed. Reg. 44039 (1976).

94. 38 C.F.R. § 36.4358 (1976).

95. Examples include the completion of common area improvements, the adequacy of reserves for repairs and replacements, 80 percent occupancy by year-round residents, a 70 percent pre-sale requirement (which may be reduced to 51 percent by special approval), and a power in the association to terminate any management contract upon 90 days notice. *See* FHLMC, SELLERS GUIDE CONVENTIONAL MORTGAGES § 3.207; FNMA, CONVENTIONAL SELLING CONTRACT SUPPLEMENT § 502.03.

96. *See* text at notes 77-80, *supra; see generally* Jackson, note 82 *supra.*

97. FNMA, CONVENTIONAL SELLING CONTRACT SUPPLEMENT § 502.03(d).

98. *See* Guide Form for Attorney's Opinion (Condominium Project), FNMA Form 1037.

99. FHLMC, SELLERS' GUIDE CONVENTIONAL MORTGAGES § 3.207.

gage of record";[100] other statutes subordinate the lien to all mortgages.[101] Obviously, under such statutes the mortgagee or other purchaser at a foreclosure sale is not subject to any liability for the assessment delinquencies of the former mortgagor, and mortgage foreclosure wipes out the association lien as to such amounts.[102] However, the real covenant which imposes the lien continues to run with the land, and assessments which accrue after the mortgage foreclosure do become the liability of the foreclosure purchaser, secured by the association's lien.

Subordination of the association's lien to the first mortgage as described above is generally thought advantageous to lenders, and FHLMC, FNMA, FHA and VA all require it.[103] It is clearly undesirable from the viewpoint of the association and its other members, since they will usually have to withstand an unusually heavy assessment to make up the delinquency of the foreclosed unit owners[104] in the long run, a series of such incidents could endanger the solvency of the association, to the detriment of unit owners and mortgagees alike. At present, however, the preference of mortgagees for priority seems well-established. Little thought seems to have been given to the consequences of a deed in lieu of foreclosure. Such deeds may be construed not to disturb subordinate liens, so the association would appear to emerge entirely unscathed.[105] In a sense this is probably unfortunate, since it serves as an incentive for the lender to employ foreclosure, a decision which is usually more costly and time-consuming for all parties.

In an effort to avoid assessment defaults, some permanent mortgage lenders require their mortgagors to pay their assessments into an impound, reserve, or escrow account similar to those customarily maintained for taxes and insurance; the lender then remits the sums collected to the association on a regular basis. Many lenders are unenthusiastic about this technique, however, since it involves much more

100. FHA MODEL ACT § 23(a), *supra* note 2; VA. CODE § 55-79.84 (Supp. 1977) (first mortgages "securing institutional lenders").

101. *See, e.g.*, UTAH CODE ANN. § 57-8-20 (1950); Brask v. Bank of St. Louis, 533 S.W.2d 223 (Mo. App. 1976).

102. FHA MODEL ACT § 23(b), *supra* note 2.

103. FHLMC, SELLERS' GUIDE CONVENTIONAL MORTGAGES § 3.207(c); FNMA, CONVENTIONAL SELLING CONTRACT SUPPLEMENT § 502.03(b)(2)(b); Veterans Administration, Policies and Procedures, Condominium Loans, 40 C.F.R. 21794, § 5(c); FHA MASTER DEED, Form No. 3276, § 19, HUD HANDBOOK 4265.1, App. 8.

104. The FHA MODEL ACT § 23(b), *supra* note 2, specifically authorizes the charging of such deficiencies against all unit owners, but the language is probably unnecessary.

105. *See* Note, 31 Mo. L. REV. 312 (1966) (discussing priority of deeds in lieu). *Cf.* Alden Hotel Co. v. Kanin, 88 Misc. 2d 546, 387 N.Y.S.2d 948 (Sup. Ct. 1976).

frequent payouts than are necessary for tax and insurance funds, and since the assessment lien, unlike taxes and assessments, is usually subordinate to the mortgage. Nonetheless, collection of assessments by the lender is generally a useful and desirable means of discouraging delinquencies and stabilizing the association's cash flow.

VI. PERMANENT FINANCING OF COOPERATIVE UNITS

Traditionally the only permanent financing involving a cooperative project was its blanket mortgage. In most respects lenders have viewed blanket mortgages as similar to loans on rental apartment buildings, although they have been concerned to some extent with the governance, internal procedures, and financial stability of cooperative corporations. Permanent blanket mortgages (as well as construction loans) on cooperative projects can be insured by FHA under section 213 of the National Housing Act.[106] Loan-to-value ratios may be as high as ninety-eight percent, a feature which makes section 213 more attractive than conventional loans, which are generally limited to eighty percent of value. While the time and complexity of processing under section 213 reduces its usefulness, the program has been fairly active in those jurisdictions in which cooperatives are popular.[107]

In recognition of the low foreclosure and loss experience of cooperatives, the Federal Home Loan Bank Board in 1975 amended its regulations to permit federally-chartered savings and loan associations to make loans up to ninety-five percent of the project's value;[108] the previous limit had been eighty percent. The regulations require completion of construction, presale of ninety percent of the value or purchase price of the units, and owner-occupancy. The cooperative itself must maintain both general operating reserves and reserves for replacements in the same amounts as are required by the FHA section 213

106. 12 U.S.C. § 1715e (1970 & Supp. V 1975).

107. From the initiation of the § 213 program in 1950 through 1975, project mortgages on 116,155 units were insured. The states in which use of the program was heaviest were (in order of decreasing use) California, New York, Florida, Arizona, Michigan, Illinois and New Jersey. California and New York were roughly equal in participation, and together accounted for 57 percent of the units. *See* U.S. DEP'T OF HOUSING AND URBAN DEVELOPMENT, 1975 STATISTICAL YEARBOOK 134 (1976). Participation has generally dropped off sharply in recent years.

108. 40 Fed. Reg. 44,125 (1975) (codified in 12 C.F.R. §§ 545.6-1(b)(1)(iii), 545.6-7(b) (1977). Note, however, that this regulation has nothing to say about loans on the security of individual co-op units, which the FHLBB General Counsel has ruled are *not* loans secured by first liens and therefore are generally ineligible as investments by federal savings associations; FHLBB OPINION, June 10, 1976, *reported in* 10 F.H.L.B.B. J. 37 (No. 6, 1977).

program,[109] and if the loan-to-value ratio exceeds ninety percent, either private mortgage insurance or a specific reserve fund maintained by the lender is required.[110]

Until recently, permanent institutional financing of individual cooperative units was unavailable; subsequent purchasers of the units either paid cash, obtained personal loans from external sources, or gave promissory notes to unit sellers to cover the non-cash portion of the purchase price. However, at least two states, New York[111] and Illinois,[112] now expressly authorize financial institutions to make loans on the security of individual cooperative units. In the absence of such legislation, the authority to do so would be dubious in most jurisdictions, since the security is a pledge of the borrower's shares of stock and an assignment of his proprietary lease, and hence is not clearly a real estate loan.[113] The New York statutes were first enacted in 1971, and have undergone a series of liberalizing amendments.[114] In their original form, they placed severe limits on the permissible maturity and loan-to-value ratio, but both of these terms are now permitted to be as generous as on loans made to owner-occupants of single-family homes. The interest rate on cooperative loans is allowed to exceed that established by the usury statute for home loans by one and one-half percent, presumably as an incentive to lenders to enter this relatively untested field. In addition, when a loan is made to finance the sale of a cooperative unit, the sale price is deemed to be the appraised value for purposes of computing the loan-to-value ratio; thus, an even larger loan might be made on a cooperative unit than a house of similar actual value.

Institutional financing of individual cooperative units was given further impetus by section 4(b) of the Emergency Home Purchase Act

109. *See* 24 C.F.R. § 213.30 (1977).

110. This fund is in addition to the reserves maintained by the cooperative itself, and must equal 1 percent of the outstanding principal balance of the blanket mortgage. This provision also applies to loans exceeding 90 percent of value on detached houses, but is little used in such cases because of the wide availability of private mortgage insurance. *See* 12 C.F.R. § 545.6-1(a)(5) (1977).

111. N.Y. BANKING LAW §§ 103(5) (banks), 235(8-a) (savings banks), 380(2-a) (savings and loan associations) (McKinney Supp. 1976-77).

112. ILL. ANN. STAT. ch. 32, § 791(d) (Smith-Hurd Supp. 1977).

113. *See* Federal Deposit Ins. Corp. v. Evans, No. 75-C-1947 (E.D.N.Y. April 14, 1976), *summarized in* 4 CONDOMINIUM REPORT 6 (No. 6, July 1976), holding the security interest in a cooperative stock and lease to be personal property and properly foreclosed under Article 9 of the Uniform Commercial Code.

114. *See* Goldstein, *Institutional Purchase Money Financing of Cooperative Apartments*, 46 ST. JOHNS L. REV. 632 (1972).

of 1974, which added a new subsection (n) to Section 203 of the National Housing Act.[115] It authorized FHA to insure individual unit loans in buildings subject to a blanket mortgage insured under section 213. Under FHA's regulations the loan must be secured by a first lien on the corporate stock certificate and the occupancy certificate or proprietary lease.[116] The loan maturity is limited to twenty years, and the loan may not exceed the difference between the FHA appraisal value of the unit and the unit's share of the blanket mortgage. Thus, the regulations recognize that a unit purchaser is always taking, in effect, subject to the blanket mortgage.

The proper method of foreclosure of a lender's security interest in the stock and lease which represent a cooperative unit is still uncertain in most jurisdictions. In *Federal Deposit Insurance Corporation v. Evans*,[117] the court concluded that the lender held a security interest in personal property which could be properly foreclosed by private sale under section 9-504 of the Uniform Commercial Code. The court rejected the cooperative member's argument that such a sale violated due process if not preceded by a hearing, a conclusion consistent with most decisions on the validity of power-of-sale foreclosures of real estate mortgages.[118] But the applicability of the U.C.C. is by no means clear, and the amibiguity is disturbing to many lenders. A statutory foreclosure procedure is needed in those states in which cooperatives are used extensively.

It is possible that the efforts of FHA, the Federal Home Loan Bank Board, and the state legislatures will make cooperatives more popular than heretofore. However, neither VA nor the two quasi-federal secondary market entities, FNMA and FHLMC, have programs to insure or purchase cooperative unit loans. In most areas of the nation condominiums are better understood, and their financing can be handled with only minor modifications of standard real estate security instruments. Moreover, the problems with which lenders have become

115. 12 U.S.C. § 1709(n) (Supp. V 1975).

116. 42 Fed. Reg. 40,430 (1977) (to be codified in 24 C.F.R. § 203.43c). Neither the statute nor the regulations explain precisely what documentation will be necessary to establish a first lien on the unit ownership; this issue is left to state law, although there are few if any state decisions on the point. Even New York law is unclear as to whether U.C.C. or real estate recording is appropriate to perfect the lien; *see* P. ROHAN & M. RESKIN, COOPERATIVE HOUSING LAW & PRACTICE § 2.01(5) (1975).

117. Federal Deposit Ins. Corp. v. Evans, No. 75-C-1947 (E.D.N.Y. April 14, 1976).

118. *See* Note, 41 Mo. L. REV. 278 (1976).

increasingly concerned in condominium unit financing, such as developer control and contributions, adequacy of reserves, the impact of rights of approval and first refusal, and the soundness of the association's major policy decisions, are all equally relevant in cooperative unit financing. From the financing viewpoint, cooperatives thus have no advantages and several disadvantages over condominiums. Hence, condominiums will probably continue to eclipse cooperatives as the preferred means of unit ownership.