

After the Mortgage Payoff: Options for the Cooperative

By Randall A. Pentiuik 6/03

Excitement is growing as cooperatives that were developed over three decades ago look ahead to the day when their original mortgages are finally paid off. Boards everywhere are asking that lies ahead, and how they should prepare. This article gives valuable guidance on how to look at the issue and to plan properly for the mortgage burning (and its corresponding HUD regulatory agreement termination) event.

First, it is important to debunk certain myths. First, there are many members who hold the belief that they will somehow automatically own their units when the mortgage is discharged. This is simply false. The legal structure of the cooperative is unaltered, regardless of the mortgage. The member will still be a member on the morning after; and he or she will still have a proprietary lease (known as an occupancy agreement). The very same board will run the cooperative as the day before. In essence, there is no change except the removal of debt from the balance sheet, and expiration of the HUD regulatory agreement.

This leads to the second myth. Many believe that the cooperative must take some action at the time the mortgage is paid off. Nothing is farther than the truth. Cooperatives are corporate entities, with perpetual existences. This means that they will continue on and on, and theoretically forever. Therefore, no rush to take some action is needed.

We do not mean to imply that the board should not evaluate its options. As fiduciaries, board members need to be ever vigilant and consider opportunities. But our point is that the cooperative does not have to do something - rather, it may choose to do so. The difference lies between Amust@ and Amay.@

So what does it mean to discharge the mortgage? Simply an end to payments to that lender, and the end of HUD=s close oversight of the cooperative through its regulatory agreement. And while there is no need to join the Aherd@ of cooperatives in a headlong rush to the future, it is advisable for boards to inform themselves of opportunities and options in the post-HUD era.

We recommend that the board undertake careful and deliberate study. It must be ready to debunk myths. It needs to have answers for members who suddenly want to convert the cooperative into condominium units in an attempt to get rich quick. It ought to be ready to lead.

As aids to the board=s study of the post-HUD era, organizations such as Midwest Association of Housing Cooperatives [www.mahc.coop] and National Association of Housing Cooperatives [www.coophousing.org] hold frequent classes. Also, a group of professionals in southeastern Michigan have held a series of forums to facilitate study and discussion on the options

[www.coopsinthefuture.com]. We suggest that boards - or committees formed to advise the boards - take advantage of these resources, as well as consulting with the cooperative's own professionals. Beyond the expertise of these professionals, there are networking opportunities with other similarly situated cooperatives that are wrestling with identical concerns, allowing the exchange of experiences.

A library should be amassed from the literature obtained in this quest for guidance within the board records. Written opinions should be requested of the cooperative's professionals on the question. This is an important proactive measure to protect the board from lawsuits brought by members, since it creates evidence that the board relied on expert advice - thus invoking the business judgment rule, which can be used to defeat challenges to the ultimate decisions made.

As noted above, the cooperative - regardless of whether it is a limited equity or a market rate type - need not take any action simply because the mortgage is paid off and HUD is gone. Beyond doing nothing are a few options that need to be understood in order to fulfill the boards' role as fiduciaries.

For the limited equity cooperative, it may consider transforming itself to a market rate. The obvious reason for doing so is to unleash the captive equity, and allow the market to determine what an outgoing member can sell his or her membership for. While this may sound appealing and a clear choice, it is not so simple. If a cooperative is located within a depressed market area, memberships may not be so marketable and capable of commanding a significant sum from buyers. This may result in vacancies and those members who remain get saddled with covering the costs of empty units.

Moreover, the membership may believe in the goal of providing low and moderate income people with affordable housing options. Thus, as a matter of policy, the cooperative may wish to remain limited equity.

Another choice, which we do not embrace, is the conversion to condominiums. While we oppose this option, it still must be studied and considered. Members will raise it because it is commonly felt that it represents a pot of gold for those who remain at the cooperative through the conversion process and then sell their condo units for significant returns. A board needs to know of the pros and cons of condo versus cooperative, and be ready to explain why the cooperative form of ownership is preferred.

As an aside, we oppose the condo option for two reasons: one is philosophical and the other is pragmatic. We believe that the cooperative form is vastly superior because it allows for pooling resources and taking care of the needs of the membership through a democratic process, engendering a mindset that promotes the community as a whole. Condos, on the other hand, promote an *Aus versus them* attitude.

Pragmatically, cooperatives are superior in how the law allows problems to be dealt with. We are allowed to use summary proceedings to evict problem members. We can screen applicants and keep out criminals. Our boards can promulgate rules and regulations to deal with evolving issues such as pets, parking, and people problems. Condos cannot deal effectively with any of these matters.

Additionally, the experience with converting to condos in Michigan is very limited. A number of legal issues, ranging from property taxation and assessment, to fairness among the membership, can and probably will give rise to expensive litigation. Why rush into a situation that is nearly certain to place the cooperative in financial jeopardy as it undergoes months or years of lawsuits and appeals? Thus, if for no other reason, we have urged caution and deliberation to our clients. We think it best, even for those who want to convert to condos, to go slow and let others pave the legal trail through a morass of issues.

One more point is important to bear in mind: HUD has stated adamantly that no cooperative funds are to be expended to undertake the condo conversion while the regulatory agreement is still in effect. This fact may be useful to slow down those who are promoting the condo conversion approach.

Beyond the issues of condo versus cooperative or limited equity versus market rate, is the option to refinance. This move achieves several goals: eliminates the original mortgage and replaces it with a new mortgage that allows for cash infusion to get some improvements done; and it eliminates the burden of operating under HUD. We discuss refinancing in greater detail in another article. But there is a side effect that is important to note for this discussion: the new lender will not let the cooperative to convert to condo so long as the refinancing mortgage is in place.

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