Comment to Proposed Regulation: Guidance on Private Transfer Fee Covenants (No. 2010-N-11)). Federal Housing Finance Agency, August 16, 2010

This comment is submitted on behalf of the Board of Directors of Beekman Hill House Corp., a New York not-for-profit cooperative housing corporation that owns the 65-unit apartment building at 425 East 51st Street, New York, New York 10022. Along with many other New York cooperative apartment buildings, we have for many years imposed a transfer fee (a "flip tax") on unit sales of two percent (2%) of the sale price; all proceeds are deposited in the corporation's capital reserve fund, as described below, in order to fund capital improvements to the building.

I. Background: Cooperatives

As you are no doubt aware, cooperative apartment owners do not own their apartments, but instead own shares in the cooperative corporation that owns the apartment building. Stock ownership entitles cooperative shareholders to lease their apartments under the terms of a so-called proprietary lease. Cooperative apartment ownership interests are thus legally not real property but securities, as reflected in New York's Martin Act, which treats the marketing and sale of cooperative apartments as offerings of securities.

The language of the proposed regulation refers only to real property, so in literal terms cooperative apartment financing should be exempt from coverage under the regulation. If that is the intention behind the proposed regulation, we strongly suggest that clarifying language be inserted to specifically exempt cooperatives. If, as many commentators have assumed, the proposed regulation is intended to cover cooperative loans, the following comment sets forth the reasons why this (i) is inappropriate and potentially catastrophic for the operations of cooperative housing corporations, (ii) will make cooperative apartment purchases unfinanceable for persons of moderate means, and (iii) will create confusion in the secondary market for cooperative financing, resulting in potential losses to both homeowners and investors.

Although the term "cooperative mortgage" is used to refer to loan financing covering cooperative shares and proprietary leases, in fact cooperative financing is done under the Uniform Commercial Code, by filing a UCC-1 Financing statement and executing a related security agreement. The only title searches done by a prospective purchaser or lender are UCC searches; title insurance is almost unheard of in cooperative purchases and loans. The only conventional real estate financing applicable to cooperative housing corporations arises from the fact that, unlike condominiums, cooperatives are allowed under local law to have underlying mortgages on their buildings.

Cooperative corporations typically maintain a capital reserve fund, not funded by monthly maintenance payments (i.e., rent under proprietary leases), in order to cover capital improvements to their buildings. In recent years we have spent, from our reserve fund: $217,000 on exterior maintenance (brickwork and pointing); $47,000 on a new roof; $272,000 on new elevators; and are now in the process of spending $110,000 on a new gas-fired heating and hot water system, for a total of $646,000 in non-discretionary capital repairs and improvements, all of which were required due to governmental requirements or failure of building systems. The large exterior maintenance costs arise from New York City Local Law 11, which requires extensive work periodically; we anticipate an expenditure of similar magnitude in 2013. In addition, recently enacted energy sustainability requirements are also likely to result in increased capital costs in the future. Our only source of funds to replenish our capital reserve fund comes

from flip taxes on the sale of apartments, aside from the imposition of special assessments, which are highly disfavored by shareholders and by potential purchasers, as discussed below. As an example of the potential impact on our shareholders of assessments for capital improvements, if our $646,000 in recent capital improvements had been paid for by assessments rather than flip taxes, it would have resulted in an assessment of approximately $8,550 for a standard one bedroom apartment. Many of our tenant-shareholders are retired or otherwise have limited incomes and would not have been able to cover this additional cost on top of monthly maintenance costs; this could have led to distress sales of apartments and possible loan defaults. In addition, increased taxes, labor and energy costs have forced us to increase maintenance charges significantly in recent years to cover day to day operating costs, resulting in further hardships for our shareholders, particularly in this economic environment.

Under New York law, apartment cooperative corporations must be not-for-profit corporations, so that no individual or entity is able to profit in any way from cooperative flip taxes, the proceeds of which can only be applied for the benefit of the cooperative, and cannot be securitized or otherwise assigned to third parties. Section 501(c) of the New York Business Corporation Law was amended in 1989 to expressly authorize "fees or charges payable to the corporation upon sale or transfer of shares and appurtenant proprietary leases that are provided for in proprietary leases, occupancy agreements or offering plans or properly approved amendments to the foregoing instruments.

Flip taxes are imposed by a two-thirds vote of the shareholders of the cooperative corporation, and are, in the case of existing cooperatives, implemented by means of an amendment to the proprietary lease, a document that is reviewed as a matter of course by cooperative lenders, and is signed by each purchaser. By definition, cooperative transfer fees cannot benefit unrelated third parties, but only the cooperative corporation, and thus all shareholders, as a whole.

II. <u>Discussion</u>

While we understand and are in full agreement with the rationale behind the proposed regulation as it relates to the general housing market, we feel that because of the unique nature of not-for-profit cooperative housing, the regulation should not be applicable to cooperatives. The following analyzes each of the points set forth to justify the proposed regulation, as they relate to cooperatives. *(FHFA language in italics.)*

"Further, FHFA has concerns that private transfer fee covenants, regardless of their purposes, may:

• *"Increase the costs of homeownership, thereby hampering the affordability of housing and reducing liquidity in both primary and secondary mortgage markets."* Flip taxes are imposed on sellers, who either purchased their units subject to these fees or voted to impose them pursuant to an open two-thirds vote of all shareholders. The alternative to flip taxes are special assessments, which are extraordinarily unpopular with shareholders, are in our experience (confirmed to us by real estate professionals) a significant deterrent to potential purchasers, and have a far more adverse impact on liquidity than the existence of a flip tax. Further, cooperative flip taxes have existed for several decades without any noticeable effect on the primary or secondary cooperative lending market.

• *"Limit property transfers or render them legally uncertain, thereby deterring a liquid and efficient housing market."* Flip taxes are openly collected by the cooperative corporation at the closing of title to the cooperative shares and proprietary lease, as a condition to the closing. If unpaid, there can be no transaction. Therefore, they do not limit transfers, or by any stretch of the imagination render them "legally uncertain."

• *"Detract from the stability of the secondary mortgage market, particularly if such fees will be securitized."* Imposing a blanket prohibition on coop transfer fees will create massive instability in the existing and future secondary market for these loans. Lenders have ample opportunity to review the provisions of the proprietary lease prior to issuing a loan, and to make their underwriting decisions accordingly. In making a cooperative loan on a property subject to a flip tax, a lender has knowingly made its bargain, and to the extent the proposed regulation will force cooperatives to repeal their flip taxes, the effect would be to put that lender in a better position relative to the cooperative corporation than it had bargained for.

• *"Expose lenders, title companies and secondary market participants to risks from unknown potential liens and title defects."* As noted above, flip taxes are openly collected by the cooperative corporation at the closing of title to the cooperative shares and proprietary lease, as a condition to the closing, which cannot occur without this payment. There are no hidden liens or title defects possible. Title companies are not involved at all.

• *"Contribute to reduced transparency for consumers because they often are not disclosed by sellers and are difficult to discover through customary title searches, particularly by successive purchasers."* As noted above, flip taxes are payable by the seller, are openly collected at the closing, and are clearly set forth in the proprietary lease. Purchasers and lenders will be aware of the flip tax because of the payment made at the closing, so there is no lack of transparency. Title searches are not applicable to cooperative transactions, and successive purchasers will be bound only by the provisions of the proprietary lease that they have signed.

• *"Represent dramatic, last-minute, non-financeable out-of-pocket costs for consumers and can deprive subsequent homeowners of equity value."* As noted above, flip taxes are payable by the seller, are openly collected at the closing, and are clearly set forth in the proprietary lease. They are neither dramatic nor last-minute, and in any event are paid by the seller, not the purchaser. The proprietary lease makes it clear to both purchaser and lender that a portion of the equity in the shares and lease must be applied in payment of the flip tax on a subsequent sale.

• *"Complicate residential real estate transactions and introduce confusion and uncertainty for home buyers."* As noted above, flip taxes are payable by the seller, are openly collected at the closing, and are clearly set forth in the proprietary lease. There is no lack of transparency, and no confusion or uncertainty is possible.

The risks and uncertainties for the housing finance market that are represented by the use of private transfer fee covenants are not counterbalanced by sufficient positive effects. This is a conclusory statement not backed up by any evidence. In the case of cooperative corporations, the benefits are extremely substantial, in the form of a reliable source of funds for capital improvements. Lenders who choose to make cooperative loans are aware of this, and prefer to make loans in buildings that have a sound financial basis with adequate reserves for future contingencies. Special assessments cannot provide this basis, since as a practical matter they can only be imposed once a specific capital expenditure has been identified; in contrast, flip taxes

enable a cooperative to create and replenish its capital reserve fund in anticipation of future and often unforeseeable capital liabilities.

"To the extent that private transfer fee covenants benefit unrelated third parties, one cannot claim that a service or value is rendered to the relevant property owner or community." Agreed, but completely inapplicable to cooperative corporations.

"Even where such fees are payable to a homeowners association, unlike more typical annual assessments they are likely to be unrelated to the value rendered, and at times may apply even if the property's value has significantly diminished since the time the covenant was imposed." Flip taxes, unlike assessments, do not add to a tenant-shareholder's monthly payment burden, but are deferred until sale. They are an integral part of our budgetary planning process, since over the years we have been able to count on an average number of units being sold per year, and to plan accordingly. In the case of low-to-moderate income tenant-shareholders, an assessment, particularly for a large capital improvement, can create severe hardships leading to loan defaults. In that case, the lien of a cooperative assessment will take priority over the cooperative loan, thereby putting the lender in a worse position than it would have been in the absence of the assessment. Diminution in the value of a cooperative is irrelevant in regard to flip taxes, as the tax is imposed only as a percentage of the sales price.

III. Conclusion

The proposed regulation seems to have had its origin in legitimate concerns that single-home developers were creating transfer fees through deed covenants that would benefit private, for-profit persons or entities and cause endless title encumbrances. However, none of those concerns are applicable to cooperative transfer fees. Flip taxes in coops are imposed by the shareholders in an open, democratic vote requiring a two-thirds majority of the owners affected, and are expressly protected under applicable state law. If shareholders prefer to have a flip tax instead of imposing special assessments, their right to do so should not be trammeled by Federal regulatory action arising from concerns not relevant to cooperatives.

Without the proceeds from flip taxes, cooperative corporations will have no readily available source of funds for capital improvements, many of which are governmentally mandated. As we have seen, assessments are unpopular, limit liquidity, operate to the detriment of lenders by coming before the lien of the cooperative loan. The proposed regulation will thus materially and adversely affect the financial stability of cooperative corporations providing homes for over 1.2 million families across the United States, the majority of whom are of moderate income.

By denying Federal mortgage financing to cooperatives with transfer fees, cooperative corporations will be forced to try to repeal their transfer fees or forgo the benefits of Federal mortgage financing. The latter course will make cooperatives unfinanceable for people of moderate income, who will then be unable to purchase or sell cooperative apartments. It may also create widespread opportunities for former shareholders who were required to pay flip taxes to litigate against cooperative corporations in an attempt to recover the sums paid, resulting in a further blow to the financial stability of cooperative corporations.

The secondary market for cooperative loans is apparently robust at present, and lenders do not seem to make any distinctions on the basis of whether or not flip taxes are imposed in a cooperative. These loans have been negotiated in an arm's-length market between lenders

buyers – if anything, cooperative loan documents are contracts of adhesion in favor of lenders – and therefore it seems to us highly inappropriate for the FHFA to seek additional benefits for cooperative lenders by prohibiting flip taxes that are essential to the functioning of cooperative corporations. The victim here is not some hypothetical unscrupulous 'developer' extracting hidden profits from unsuspecting purchasers, but hundreds of thousands of individual tenant-cooperators.

If the proposed regulation takes effect as drafted, what will be the effect on the secondary market for cooperative loans? As there is no way for potential investors to distinguish between loans with flip taxes and those without, it is likely that the entire market will be tainted by association with this prohibition, rendering the secondary market illiquid. Further, future cooperative lending activity will be paralyzed until cooperative corporations have a chance either to repeal their transfer fees or elect to proceed without the benefit of Federal mortgage financing. This will result in a deep freeze on sales, plummeting prices, and an eventual surge in loan defaults. These presumably unintended consequences of the proposed regulation will cause an enormous degree of harm to cooperative tenant-shareholders for no appreciable benefit.

Another serious question arises regarding the underlying real property mortgages on cooperative apartment buildings. Are those mortgages 'tainted' because the corporation imposes a flip tax on sales of apartments? If so, the result will be that thousands of cooperative apartment buildings will be unable to refinance their underlying mortgages, leading to widespread foreclosures and the complete wiping out of shareholders' equity in their units. What conceivable rationale could FHFA have in order to advocate such a result?

It may be that the primary (as opposed to the stated) motivation behind the proposed regulation is to unilaterally improve the position of foreclosing cooperative lenders at the expense of cooperative corporations. If a lender can squeeze a few extra dollars out of a cooperative foreclosure by avoiding payment of flip tax, that may ease the burden on Fannie Mae/Freddie Mac to a small degree. However, the severe financial problems affecting the Federal mortgage agencies did not arise from cooperative loans with flip taxes, but from a wild, speculation-fueled lending frenzy in the single-home market. It seems to us that taking away that portion of the sales price that rightfully belongs to the cooperative corporation under New York law, in order to increase the recovery of a few lenders who made bad lending decisions is monumentally unfair, and will result in hardship for several hundred thousand homeowners.

Given the clearly expressed intention of the New York State Legislature to authorize the imposition of flip taxes, the proposed regulation attempts to do by administrative fiat what the FHFA could not do directly, which is to pre-empt state corporation law and to override the will of cooperative shareholders as expressed in binding contracts. It is unclear whether even Congress would have the power to do this under the United States Constitution, and for the FHFA to seek to do so strikes us as far in excess of its constitutional and statutory authority.

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