

**Condos Restricted in Financing of Repairs**

*By Benjamin Weinstock and Joanne S. Agrippina*

New York's first condominiums date back to the early 1960s, an era that witnessed the initial wave of intense condominium construction and conversion. Indeed, the pioneering enactment in 1964 of New York's Condominium Act<sup>1</sup> paved the way nationally for the expansion of condominium ownership. Today, some 38 years later, these early condominiums are entering their so-called "second-generation."<sup>2</sup> While some have aged better than others, many are encountering the need for significant capital repairs, replacements and improvements. The common problem they face is how to finance the major expenditures that are necessary.

Making matters worse for these second-generation condominiums are unexpected increases in insurance and security costs, and unanticipated state and local mandates (such as mandatory facade inspections and underground storage tank replacements) all of which are depleting resources that could have otherwise been used to defray second generation costs. Unfortunately, New York and federal laws do not adequately address the need of condominiums to borrow and, so, condominiums are severely restricted in their ability to raise needed funds.

For cooperatives, the prospect of a large financial outlay generally does not present a significant impediment. A co-operative is owned, usually in fee, by a co-operative corporation whose board of directors is authorized to mortgage the cooperative's ownership interest in the building and the land. Banks and other lending institutions are comfortable both with the security they receive and the principal remedy available to

them in the event of a default on the loan, namely, the ability to foreclose the mortgage.

Condominiums, on the other hand, face enormous obstacles when it comes to borrowing money, due almost entirely to their unique co-ownership structure. Consider the condominium as a single parcel of property that has been subdivided into separate units.<sup>3</sup>

Each unit is separately owned by a participant in the "condominium regime."<sup>4</sup> The remainder of the property, known as the condominium's "common elements," is co-owned in undivided proportionate shares by all unit owners and is administered by a governing body called the board of managers operating under a defined set of rules set forth in the condominium's Declaration and By-laws.<sup>5</sup>

The co-ownership structure of the condominium is similar to a tenancy in common among the unit owners. Title to the units and common elements is vested in the unit owners. The board<sup>6</sup> (and the condominium itself) owns neither.<sup>7</sup> Accordingly, unlike a cooperative that is able to offer a mortgage on the entire fee (or ground lease) interest of the cooperative as security to a lender, a condominium's board has had no meaningful real property interest to offer. In fact, § 339-l(1) of the Condominium Act specifically prohibits the creation of a lien of any kind against the common elements

unless unanimous consent is obtained from all unit owners.<sup>8</sup>

In 1997 the New York Legislature addressed this growing dilemma facing the aging condominium inventory by adding § 339-jj to the Condominium Act.<sup>9</sup> This new law was intended to enable condominiums to fund repairs and improvements by borrowing.



*Benjamin Weinstock*



*Joanne S. Agrippina*

Condominiums face huge obstacles when borrowing money for major expenditures. This article discusses a recent change to the condominium law that expands the opportunity for condominium boards to fund major expenditures for building repairs and upgrades, and outlines alternative financing methods.



**Benjamin Weinstock**

is a Partner and Co-Chair of the Firm's Real Estate Department.

He can be contacted at: (516) 663-6555 or [bweinstock@rmfpc.com](mailto:bweinstock@rmfpc.com)

**Joanne Agrippina**

is an attorney in the Real Estate Department.

She can be contacted at: (516) 663-6674 or [jagrippina@rmfpc.com](mailto:jagrippina@rmfpc.com)

*For the latest information visit our website [www.rmfp.com](http://www.rmfp.com)*

The balance of this article will address the function of § 339-jj and its effectiveness.

**Before the Law**

To begin, however, one must note that prior to the enactment of § 339-jj, a loan to a condominium was simply out of the question and a condominium board of managers had but two means for raising money, namely, reserves and assessments.

Reserves are those "rainy day" funds set aside over time to fund future repairs, improvements and other major expenditures. Turning to these reserves as the need arose was assumed to be the best solution to a board's money woes. Unfortunately, more often than not condominiums had not adequately funded their reserves. Typically they were simply too small to pay for major expenditures. Apparently, first generation owners were not concerned with funding repairs, improvements and other related costs that would be needed 20 or 30 years in the future. Their primary interest, understandably, was keeping common charges low. Thus, reserves are rarely a solution to the condominium's funding problem.

The board's second alternative to fund major expenditures is an assessment, a common feature of condominium living. Assessments are a way for a board to spread the cost of a much needed repair or other expense to the entire unit-owning body. An assessment is fixed by the board and is generally payable monthly. It will usually last for a set period of time until the repair or other expense has been paid for. For smaller periodic projects (e.g., lobby redecoration, elevator cab upgrades and roof repairs), assessments serve as a very reasonable and equitable means of raising necessary capital. Assessments for major capital expenditures, however, are quite another story. Consider the following example.

Weather and time have rotted the balconies of a 35-year-old, 50-unit, waterfront condominium. The balconies are no longer stable, and both the board and the building department have advised unit owners not to use the balconies until they can be replaced. The concerns are two-fold: the safety of the unit owners and the safety of those passing beneath the unstable balconies. The condition is so precarious that all balcony doors have been sealed. Engineering studies estimate the cost of repair at \$2 million. The condominium's reserves are less than a tenth of the needed sum, and the board must raise the money quickly to address this urgent situation.

The board considered imposing an assessment on each of the 50 unit owners until it realized that the amount would average \$40,000 per unit. This is not an obligation that can be amortized by the unit owners over 15

or 30 years. Rather, it is an immediate levy to be paid over the six-month construction period. This is simply too costly for the unit owners, particularly those who are retirees.

On top of the enormous financial hardship of the assessment, it is viewed as an unfair apportionment of the project cost. After all, the assessment is an immediate investment that garners a long-term benefit for future unit owners, but in no way spreads the cost to those future owners.

To exacerbate the problem, a large assessment would likely have an enormous adverse effect on the marketability of the individual units. Potential purchasers of condominium units are always concerned about current or impending assessments, and the large assessment contemplated by our example would surely deter potential purchasers or significantly impact sale prices.

Raising the large sum of money was improbable, if not impossible, by utilizing reserves or assessments, and the board of managers turned to § 339-jj.

**Financing Mechanism**

Under § 339-jj a board of managers is vested with two powers that were previously non-existent, or ambiguous at best. First, the board has the power to incur debt on behalf of the condominium, and second, it has the ability to offer lenders meaningful collateral to secure the loan.

Section 339-jj(1) specifically empowers the board to incur debt in two circumstances: (i) for any purpose, to the extent authorized by the condominium Declaration or By-laws; and (ii) for the purpose of funding maintenance, repairs, additions, improvements, replacements, depreciation, obsolescence, working capital, bad debts and unpaid common expenses subject to any limitations set forth in the condominium's Declaration or By-laws, provided the debt is incurred no earlier than the fifth anniversary of the conveyance of the first unit and is authorized by a majority of unit owners.

Section 339-jj(2) also authorizes the board to provide lenders with meaningful security by granting the board of managers (i) the power to assign to a lender its right in and to future income and common charges; and (ii) the power to create a security interest in, assign, pledge, mortgage or otherwise encumber funds or other real or personal property held by the board. In doing so, § 339-jj(2) takes into account the fact that while a lender may well be satisfied with an assignment of future income and common charges, this collateral is meaningless unless the lender is able to ensure that it will be able to enforce its lien in the collateral in the event of a default under the loan.

Absent § 339-jj(2) the board of managers has exclusive control over common charges.



But, § 339-jj(2) establishes three very significant and powerful lender protections. First, boards are given the right to designate common charges as a trust fund for the payment of any debt incurred. Second, boards may agree that common charges may be increased, at the lender's direction, if additional sums are needed to pay an amount due under the loan. Third, in the event of a default under the loan, § 339-jj(2) expressly gives the lender the right to step into the shoes of the board and file and foreclose liens in the lender's own name against individual defaulting units.

The § 339-jj(2) financing mechanism ultimately works like this. The board of managers obtains a loan and executes a note on behalf of the condominium. The board assigns, much like an assignment of rents, the board's right to collect common charges and other future income together with the board's right to enforce the common charge obligation. The lender also receives a security interest in the board's bank accounts, reserve funds and other assets, but not the real property or any common elements.

The common charges are increased to cover the monthly debt service of the loan, and the unit owners are notified of the new monthly payment amount. Even owners who were not in the majority that approved the loan are subject to the increases in common charges. Contrasted with an assessment, the unit owners have an affordable monthly payment, and if they sell their unit, the new owner who will share the benefit of the improvements made to the building will likewise pay a portion of its cost. Applying the Law

At first blush, § 339-jj seems like a perfect solution to the problem. Yet, very few condominiums have availed themselves of this borrowing structure. We believe that there are several issues that deter condominiums from proceeding with § 339-jj financing.

First, from a procedural perspective, there is no guarantee that a board will be authorized to incur debt. Under the statute, the board's authority to incur debt is conditional. It may incur debt on behalf of unit owners only "to the extent authorized by the Declaration or the By-laws" of the condominium or upon approval of a majority in interest of the unit owners.

Of the Declarations and By-laws we have examined, the overwhelming number do not have debt authorization provisions. This is not surprising as all first generation Declarations and By-laws were written before the 1997 enactment of § 339-jj.

Likewise, there is no guarantee that a majority of unit owners will approve this kind of financing arrangement. The primary

concern for unit owners is usually the question of personal liability, whether it be for their pro rata share of the debt or for the entire loan. Unit owners are also concerned about the amount of the monthly common charge increase and their ability to afford it, especially those owners living on fixed incomes. Acquainting unit owners with this kind of financing and addressing their many questions and concerns is essential to calming the initial nervous spell of the owners. The board surely will need to hold frequent informational meetings to solicit the needed approval.

#### **Tax Deduction**

The board will also examine, usually with the aid of counsel and its tax adviser, the availability of a tax deduction to the unit owners for the interest expense associated with the loan. Internal Revenue Code § 216(a)(2) provides that a tenant-stockholder of a cooperative housing corporation may deduct a proportionate share of the interest allowable to the corporation on its indebtedness contracted "in the acquisition, construction, alteration, rehabilitation, or maintenance of the houses or apartment building" of the cooperative.

There is no comparable deduction for condominium owners. Thus, albeit that the unit owners are funding the interest payments on the condominium's loan, there is no tax benefit that can trickle down proportionately to them. This is a strong disincentive to many unit owners and may negatively impact chances for majority approval.

There are, however, two complicated financing alternatives that could provide unit owners with the desired tax deduction. One is used in conjunction with a § 339-jj loan, the other stands alone. First is the untested method of providing individual mortgage loans from the condominium to the individual unit owners in connection with a § 339-jj loan to the condominium. This would work in the following manner. The board imposes an assessment on each unit owner. The board then borrows from a § 339-jj lender an amount equal to the total of all assessments. The board uses the proceeds of the § 339-jj loan to lend to each unit owner the amount required to pay his or her assessment.

Each unit owner secures the loan from the board with a non-recourse mortgage on his unit. The unit owners make monthly payments on their mortgage loans to the board. With the money the board receives each month, it pays the monthly debt service on the § 339-jj loan to the lender. To facilitate the sale and refinancing of the units, the unit mortgages are subordinated to any new



#### **Ruskin Moscou's Real Estate Department Services**

- Acquisitions and Conveyances
- Commercial Leasing
- Mortgage Financing (Conventional and Government Subsidized)
- Secured Lending
- Zoning, Development and Subdivisions
- Construction Agreements
- Seniors' Housing
- Co-op/Condominium Conversion
- Ownership Agreements
- Brownfields Rehabilitation
- Environmental Compliance
- Title Issues
- Real Estate Litigation
- Foreclosures
- Construction Lending

#### **Ruskin Moscou Faltischek, P.C.**

190 EAB Plaza, East Tower, 15th Floor, Uniondale, New York 11556-0190  
516-663-6600 • www.rmfp.com

mortgage placed on the unit by the unit owner, and the unit mortgages are fully assumable by a purchaser in the event of a sale. With individual unit mortgages in place, the unit owners would be eligible to take tax deductions for the interest paid, subject to the otherwise applicable limitations on home mortgage interest deductions.

In theory this alternative sounds like a viable solution to the tax deduction issue. However, there are several practical problems that may weigh against its use. First, it has not been formally reviewed by the IRS. While tax lawyers have assured the authors that it will work under the Internal Revenue Code, it has never been tested.

Second, it is likely that the marketability of the units would be hindered by the unit mortgages as the structure would be too complicated to explain to prospective purchasers and would probably impact the sales price. Third, if one could find a willing purchaser, could the purchaser find a lender that would permit the subordinate unit mortgage? Also worth considering is the fact that some unit owners, perhaps those owning their unit as a second home, or those who do not itemize deductions on their tax returns, could not take advantage of the tax deduction but still would be saddled with the unit mortgage.

### Home Equity Loans

A second structure to consider which is independent of a § 339-jj loan is an assessment by the board to the unit owners which the unit owners fund with individual home equity loans. There are several drawbacks to this method as well. While a home equity loan could produce a tax deduction, the loan is not assumable by a prospective purchaser and would be due and payable upon the sale of the unit. Thus, future owners will benefit from, but will not pay any part of, the improvements.

Furthermore, the cost of implementing the program would be very high given the aggregate number of title premiums, counsel fees, recording charges, loan points, credit searches and mortgage taxes that would have to be paid for the home equity loans. This, of

course, assumes that every unit owner would qualify for the home equity mortgage, and that there is sufficient equity in each unit to support the loan. In the end, this method is nothing more than an assessment which requires individual unit owners to find their own funding sources.

A final, and perhaps the most frustrating issue for boards and supporters of § 339-jj alike, is the fact that a majority of lenders are still unwilling to make condominium loans. In the five years that have elapsed since § 339-jj's enactment, lenders have not embraced the 339-jj financing alternative as hoped. Surprisingly many lenders, rather than looking for the opportunity to be in the vanguard of this new lending niche, have taken the opposite approach and have ignored § 339-jj completely. Condominium boards are left either with the pre-Section 339-jj alternatives of reserves or assessments for financing major expenditures, or are subjected to the difficulty of negotiating a loan package with a single willing bank that is (and knows that it is) the only game in town.

While § 339-jj offers a progressive alternative for financing the major expenditures needed by an increasing number of second generation condominiums, § 339-jj has not solved the condominium borrowing dilemma. Even if a condominium can overcome the obstacles set forth in this article and the condominium has a willing body of unit owners and a board fully authorized to borrow, the condominium may still face enormous difficulty finding a lender to make the loan.

There is a simpler solution. If the Condominium Act were to be amended to permit boards to mortgage condominium properties to the same extent as cooperatives, and if Internal Revenue Code § 216 were to be amended to allow interest deductions on such mortgage interest to pass through to the unit owners, condominiums would stand on equal footing with cooperatives. Obviously, we favor the much needed state and federal amendments. Until this happens, the barriers to condominium lending, though surmountable, will inhibit the use of § 339-jj. ■

(1) Condominium Act of 1964, ch. 82, 1964 N.Y. Laws 96 (codified at N.Y. Real Prop. Law art. 9-B (McKinney 2001)).

(2) Robert E. Parella, "1996-1997 Survey of N.Y. Law," 48 Syracuse L. Rev. 821, 829 (1998).

(3) Matthew J. Leeds & Joel E. Miller, "Condominium Act Addition Gives New York Boards of Managers Effective

Borrowing Ability," 73 St. John's L. Rev. 135, 137 (1999).

(4) Id.

(5) Id.

(6) References in this article to a board, mean the board of managers of the condominium.

(7) Boards are permitted to own units, but the discussion of that power is

outside the scope of this article. The point of contrast here between cooperatives and condominiums relates to the ownership of the land and building.

(8) N.Y. Real Prop. Law § 339-l(1) (McKinney 2001).

(9) N.Y. Real Prop. Law § 339-jj (McKinney 2001).



### Firm Capabilities

- Corporate & Securities
- Corporate Governance
- Employment
- Energy
- Environmental
- Financial Services, Banking and Bankruptcy
- Health Law - Transactional and Regulatory
- Intellectual Property
- Litigation
- Municipal & Regulatory Affairs
- Real Estate
- Construction
- Seniors' Housing
- Technology
- Trusts and Estates
- White Collar Crime & Investigations

## Ruskin Moscou Faltischek, P.C.

190 EAB Plaza, East Tower, 15th Floor, Uniondale, New York 11556-0190  
516-663-6600 • www.rmfp.com