ARE YOU CONSIDERING THE PURCHASE OF A

"LIMITED EQUITY" COOPERATIVE SHARE?

If you are thinking of purchasing a "Unit" in a Limited Equity Cooperative (LEC), you might first want to understand some of the differences between a condominium and an LEC. Please understand that I am not an attorney or an accountant and am not in any way providing any legal or tax advice. But I have had some experience with LECs and I want to give you some food for thought, and perhaps some questions you can pose to the developer or the owner of the LEC interest you are considering buying.

The following issues raised may, OR MAY NOT, be relevant to all LECs, but are relevant to some of them. It would be wise to determine the rules and regulations that apply to the specific LEC you are considering BEFORE you agree to purchase an interest.

First of all, if you purchase a "Unit" in a typical LEC, you are NOT purchasing real estate. What you are purchasing is a membership interest (a "Share") in the LEC, the cooperative housing corporation that owns the real estate. You are then given a "proprietary lease" for a particular unit in the project and in effect become a tenant of the LEC. These distinctions can be important for a number of reasons, as outlined below.

A person purchasing a Share in an LEC becomes a Member of the LEC. Typically, the initial Members must pay a fixed percentage of their "equity" at closing (usually something like 20%, 33%, 66% or 95% - like a down payment) and finance the balance through an arrangement with the LEC that is like a "Share Loan". The rights the LEC holds in your Share is the collateral the LEC holds to secure the loan.

Generally, the LEC has an overall mortgage or land lease arrangement for the entire project to cover the amount by which the initial cost of the project exceeds the equity contributed by the initial Members. The LEC is responsible for paying the ongoing mortgage or lease payments. Also, in many cases the LEC pays the real property taxes on the project. Each Member of the LEC pays a monthly fee to cover such Member's portion of the mortgage or lease payment and real property taxes, as well as the other expenses involved in running the LEC. The monthly fee will vary depending on how much the Member has paid at closing and what portion of the real property taxes are allocated to the Member's unit, but even Members who have paid 95% at closing must pay fees to cover the mortgage or lease payment and real property taxes.

Subsequent buyers of the initial Member's Share take over the initial buyer's payment obligations, but the LEC does not normally offer any other financing to assist subsequent buyers. In effect, the buyer of your Share would be assuming your portion of the overall mortgage or lease obligation and would need to come up with the additional funds necessary to acquire your equity. A buyer needing outside financing to purchase your

Share will have very limited choices. The buyer would have the right to get a Share Loan from a bank, but those are hard to come by. Banks are generally reluctant to give such loans as they are only backed by an assignment of the Member's membership interest in the LEC. Because the Member's interest in most LECs is NOT real estate, Members cannot mortgage their interest as they could with a condominium purchase.

Because the LEC is "Limited Equity", it also means "Limited Appreciation". Typically, Members selling their Share in the LEC only have the right to get back what they paid for their Share plus a predetermined appreciation rate to recognize inflation. (An appreciation rate of 2% is common, but some LECs specify a higher rate of appreciation and others specify a lower rate. **<u>Check with your developer or seller to be sure.</u>**) The buy-in price as so appreciated is sometimes called the **Transfer Value.** Any equity appreciation over and above such Transfer Value belongs to the LEC or to the party who holds the lessor's interest under the LEC's land lease arrangement. However, if the market value of the Member's Share is less than the Member's buy-in price, the Member typically absorbs the loss.

The LEC generally has the right to buy back a Member's membership interest upon death of the Member (unless taken over by the spouse), or if the Board determines the Member is unable to live independently in the project, or if the Member desires to leave the project. If the LEC buys back a Member's interest, the purchase price received by the Member will be the Transfer Value. **<u>Be sure you understand the Board's rights and obligations to re-purchase Shares.</u>**

If the LEC does not exercise its option to purchase the Member's interest, the Member may sell the Share for **<u>whatever price it can get</u>**, but not more than the Transfer Value. The LEC may assist in selling the Share, often for a fee. The buyer must be approved by the Board of the LEC. The Board may look at the financial and social responsibility of the prospective buyer before approving the sale. The LEC may maintain a waiting list and charge a fee or deposit to those folks wishing to be on the waiting list.

Because of the cap on the selling price allowed under the rules and regulations governing the LEC, the amount Members receive for their Shares may be significantly less than the fair market value. Developers and Cooperative Boards often maintain a waiting list of potential buyers hoping to buy into the LEC, and cite this as a virtual guarantee there will be a buyer willing to purchase a Share on the re-sale market at the "guaranteed" appreciation rate. **However, there is no guarantee there will be persons on the waiting list who are ready and able to purchase.**

Up to this point, Buyers have been willing to acquire Shares at the Transfer Value for most LECs. However, as more and more LECs come to the marketplace to meet the current demand (there are at least 46 LECs in the Metro area already, with several more in various stages of development!), there may be fewer and fewer folks on the waiting list for any particular LEC. This will be especially true in the coming years as the Baby Boomers pass through their housing market years and move on to the assisted living or nursing home phase of their lives.

In the event a Limited Equity Share goes on the market and there are no takers at the "appreciated" value, owners of such Shares are free to take whatever they can get for their Share. So if the Transfer Value were $200,000 based on the initial investment and 2% per year appreciation, but there are no buyers from the waiting list who are willing and able to purchase at $200,000, your Share may not sell. However, if someone would be willing to pay $175,000 for the Share, there is no prohibition against the owner selling for less. I can imagine a scenario in which a Share owner passes away and the heirs wish to dispose of a Share quickly so as to avoid the ongoing monthly obligations of Share ownership, so they take considerably less than was anticipated**. In essence, there is a cap on the appreciation (upside) of a Share, but there is no floor on the downside.** It will all depend on the viability of the market and the existence of a waiting list of ready buyers.

The LEC collects a monthly payment for carrying costs and financing fees. This obligation continues even if a Member dies or moves away. If the LEC does not purchase the Share and there is no buyer on the waiting list, the Member (or his or her estate) must continue to make the monthly payments. Carrying costs cover payment of the mortgage or land rent, taxes, insurance, utilities, operating costs, management fees, and replacement reserves. Unpaid carrying costs become a lien on the Member's membership interest.

If the Member fails to make a monthly payment, the LEC can foreclose the lien and exercise its other rights against the Member's membership interest. The Member has 90 days after notice of the foreclosure sale to make up the missed payments. If the default is not cured, the Member can lose his or her membership interest in the LEC and the Member's right to use the unit under his or her proprietary lease, effectively wiping out the Member's entire investment. The LEC has the right to bring an eviction action to physically remove the Member from the unit if the Member does not leave at the end of the cure period. **<u>Be sure you understand the Board's right to foreclose and your right to cure the default.</u>**

Since all Members of the LEC share the cost of paying the underlying mortgage or land rent and the costs of operation and maintenance, a default by one Member may require the LEC and the other Members to cover the defaulting Member's costs. If a Member's interest is foreclosed, the LEC could sell the unit to another purchaser and use the proceeds to cover the carrying costs of the unit. If there are enough defaults to cause the LEC to run short of cash, the LEC may need to increase the fees charged to the remaining Members to cover the shortfall.

All that being said, here are some issues to consider when comparing buying into an LEC rather than a condominium:

1. Limited Appreciation. As I described above, there is a cap on the amount you can get on the resale of a Share in an LEC. What is that cap? 1%? 2%? 3%? **FIND OUT!** There is no cap on sale of a condominium unit, so in an appreciating market, a condo may be the better investment. In a depreciating market, neither may be a good investment.

2. Remodeling. There may be little to be gained by doing major remodeling in an LEC. The cost of the remodeling may not be recoverable at sale because of the cap on the selling price. **Check carefully with the developer or seller** to find out if remodeling costs can be recovered (added to the value of the Share over and above the appreciation rate allowed). In contrast, owners in a condominium can always remodel to suit their needs and personal tastes and hope to recover the investment on eventual sale. (The monthly fee in an LEC often does cover periodic replacement of floor coverings and appliances in all of the units, which helps keep units owned by long-term residents in better shape, but you would pay for any upgrades of your unit over the standard replacement items).

3. Privacy. Generally, the LEC owns and therefore controls all the individual dwelling units as well as all the common elements. Your interest in your unit is more like a lease than ownership of the space. The LEC Board may have a say in what you can do in the way of remodeling your unit, when you must move out if you are no longer able to live independently, and in other matters that affect

your privacy and personal decisions. In condominiums, the owners own their own dwelling units and the Condominium Board only has a say on what an owner can do inside a dwelling unit if it unduly affects the building or the other residents. **<u>You may want to investigate what rights your Board has to determine the remodeling you might choose to do, or the length of the time you will be allowed to remain in the LEC.</u>**

4. <u>Restraints on Sale</u>. Generally, your Share in the LEC cannot be purchased by anyone who is not approved by the Board. Condominium buyers do not need approval to purchase a condominium unit. Some LECs are selective in approving who can qualify as Members. In one real life example, an owner of one cooperative Share had two prospective buyers rejected by the Board before he was able to sell the unit; it took him a full year to find an "acceptable" buyer. **<u>You may want to investigate the rights the Board has in terms of approving subsequent Share purchasers.</u>**

5. <u>Access to Personal Information</u>. As all Members share the financial obligations of the LEC, it is important to know whether incoming Members can meet these obligations. As part of the LEC approval process, prospective buyers must often provide financial information and other evidence that they qualify as Members and the Board generally may conduct credit checks and criminal background checks on them. Board members (and possibly other Members) of the cooperative would potentially have access to this personal information. As

condominium buyers do not need Board approval to purchase a condominium unit, their personal information (other than their age) remains private. **<u>You may want to investigate what private information must be provided to the Board by you or a subsequent buyer, and who has access to such information.</u>**

6. <u>Financing Limitations</u>. It is difficult to obtain financing for purchase of a cooperative Share other than the Share Loan offered to the original Member. A Share in an LEC is treated as personal property, so real estate mortgages are generally not available. Share Loans from banks secured by the owner's membership interest in the LEC are not readily available. Original Members may want to purchase at low equity (such as 20%) and carry the interest payments, not because they can't afford to pay more but because there will be fewer buyers who can come up with the cash to make a high-equity initial investment. Condominium units on the other hand are treated as real estate, and buyers can finance their purchase using normal real estate mortgages or even contracts for deed or home equity loans.

7. <u>Reverse Mortgages</u>. As a person ages, he or she may not be able to pay the rising carrying costs of owning their own home. Owners of a condominium can obtain reverse mortgages that will enable them to continue living in their home for many more years. As cooperative investments are personal property, owners of a cooperative Share have no such option.

8. Tax Advantages. Interest payments on Share Loans and the underlying mortgage, and property taxes for an LEC are generally deductible in the same manner as a condominium or other home, but only if the LEC meets certain requirements under the Internal Revenue Code. **CHECK WITH YOUR ACCOUNTANT to make sure the LEC is set up and operated in the manner required by the Code.**

9. Health Issues. As a person ages, he or she may have difficulty continuing to live independently. In most instances, the decision to provide outside services or moving to care center is best handled as a private decision by family members. The Board may have the power to require a vulnerable person to move out of the LEC without taking into account the personal factors that impact such decisions. A condominium Board cannot unilaterally make these kinds of decisions.

10. Financial Difficulties. Since a Share in an LEC is normally treated as personal property, Members who fail to make payments due to a financial difficulty will generally have only 90 days to cure the default (make up the missed payments) after notice of the foreclosure. If the default is not cured, the owner may lose his or her entire investment. In contrast, the owner of a condominium unit normally has a redemption period of six months or more after the foreclosure sale to cure a payment default, whether the default is for failure to pay condominium fees or a mortgage loan.

11. Economic Collapse. If enough owners fail to pay their cooperative fees, the cash flow may not be sufficient to pay the LEC's mortgage or land lease obligations, tax obligations and other costs. In such instance, the members of the LEC would need to raise their fees to cover the shortfall or risk losing their entire interest in the project. A few years ago, members of a senior housing cooperative in Edina were sued individually by a bank that had filed for foreclosure of the mortgage loan on the entire project. Eventually, the project was converted into a senior condominium. While condominium owners also face some issues in the event fees are not paid, their fees would only need to be raised to cover utilities and other operating costs. Condominium fees do not cover mortgage payments or taxes as they are the responsibility of each individual owner. Consequently, condominium owners who continue making their payments don't face the threat of mortgage or tax foreclosure because of the financial difficulties of the LEC or the other owners.

So, be careful! Ask questions and fully understand the answers. Beware if you are told that the guarantee of 2% per year appreciation is assured because there will "always" be a waiting list. Talk with current owners to find out what you can expect. Read carefully the LEC's Articles of Incorporation, By-Laws, Declaration, Subscription Agreement and Rules and Regulations. Inquire about the availability of Share Loan financing. Ask about the terms of any underlying mortgages and land lease arrangements. Make sure you understand how the LEC works, how and by whom it is managed, and what you will be required to pay for and how much. If you have legal questions about investing in an LEC, consult with an attorney who is versed in cooperative housing law. And remember, the above comments may not apply to all LECs, so **<u>check carefully into the LEC you are considering.</u>**

Still want to buy a Share in an LEC? **That's GREAT!** I just wanted to give you some background information and some suggestions on what questions to ask.

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