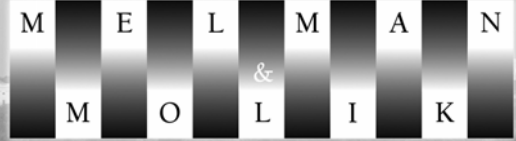




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DC Co-op Primer

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When buying a home, most purchasers distinguish between an apartment and a house. The “apartment” term is often synonymous with condominiums. Missing from this lexicon is the cooperative apartment or “co-op,” a long established form of home ownership that actually pre-dates condominiums.

Locally, many savvy purchasers find the concept and operation of cooperatives confusing. Our primer is intended to highlight the nuances between co-op and condo ownership for the first time buyer as well as the experienced purchaser. This primer should demystify how co-ops work and other salient points buyers and even sellers should know. You will find insight into this form of homeownership and information useful in selecting a real estate agent for your purchase or sale.

Cooperatives, long the mainstay in Manhattan, are also found in cities with large numbers of transplanted New Yorkers (urban areas in general and particularly Washington DC, Chicago, and parts of Florida). The District has over 100 different cooperatives ranging in size from a four unit house to large buildings with hundreds of units.

Many of the premier buildings in town are co-ops. These residences are so well known that locals can refer to them by name: the Watergate, the Broadmoor, and The Westchester to name a few. When a buyer overlooks cooperatives as part of their Washington home search, they rule out these and other treasured buildings that combine interesting histories, unique and varied architecture, and most importantly sought-after locations.

Similarities with condominiums

- Privileges of home ownership
- Deductibility of mortgage interest

Differences with condominiums

- Board approval process
- Lower closing costs – no transfer and recordation taxes. No title insurance
- Property tax is collected centrally as part of co-op fee. A portion of the fee is thus tax deductible
- Not friendly to investors, can impose rental restrictions

Things to check property by property

- Availability of financing
- Pet policy
- Inclusion of utilities

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History of Cooperatives in Washington

Two cooperative projects proceeded the local boom period of the 1920s. The Concord was built in 1891 at the corner of New Hampshire and Swann Streets NW and was razed in 1962. 2852 Ontario Road NW, was built in 1909 and still exists today. The original owners bought the land and developed a building. These were smaller projects in nature.

Co-ops hit their stride when rent stabilization regulations, held over from World War I, affected the profitability of some of the grand apartment houses. Many noted DC developers and architects, among them Harry Wardman, Morris Cafritz, and the Warren Brothers, created the first co-ops. These sales were often handled as a co-op conversion – where apartment renters could “buy” their apartment homes. These early conversions were “stock” cooperative – a stock certificate existed in addition to a proprietary lease on each unit.

In 1928, the Parkway, a new construction project at 3220 Connecticut Avenue NW, went bankrupt after establishing the corporation when only 25 of the 83 units had been sold. The initial purchasers lost their downpayments and many were later evicted. The US House of Representatives held hearings on the Parkway debacle, and as a result, the developer was arrested for fraud, and the original shareholders were reprimanded for “capriciously investing in an unsound project.” New regulations were established after which cooperatives could not incorporate until 80% had been sold, prior to which all deposits were to be held in escrow. Such regulations govern much of what happens with condominium and cooperative conversions today.

In 1948, the Boardmoor and Westmoreland cooperatives became membership cooperatives rather than stock cooperatives in order to ease reporting requirements. The “Perpetual Use and Equity Contract,” now called the “Cooperative Ownership Contract,” served to combine the stock certificate and the proprietary lease. The idea of a “non-stock” cooperative emerged. Both of these projects still exist today, and this form of co-op ownership is very popular.

Prior to the 1970s, purchasing a cooperative required either all cash or very significant cash down payments. Financing became easier when banks began pilot loan programs for co-op resale establishing recognition agreements with the co-op, so that the lender could hold a security interest in the borrower’s unit. By being able to “attach” to a security interest, lenders were able to provide more competitive terms.

Starting in the late 1990s, loans of up to 95%, and more recently even 97% became possible with no interest rate premium over the purchase of condominiums or fee-simple homes. Co-op mortgages are often referred to as share-loans – a loan for the purchase of shares of a corporation.

The general public is more often familiar with the idea of condominiums, which have succeeded in both urban and suburban centers and as residential and commercial entities. A condominium can generally be defined as a fee simple ownership of a specific *part* of a property and an undivided interest in the common areas of the property. Legislation was necessary to define this joint ownership. Condo

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ownership is evidenced by a deed and typically a condominium rider to the deed. By comparison, a combination of shares in the co-op, membership agreements and an occupancy agreement evidence cooperative ownership.

Condos have proven remarkably resilient, re-sellable, and marketable. The condominium concept did take off, but co-op buildings remain and new co-op projects do still occur. Co-ops can work today where neighborhood concessions or developer incentives can bring a project together more quickly than a protracted and contentious zoning hearing for a condominium conversion. In 2006, the Chastleton in Dupont Circle was converted to co-op rather than condos to allow most of the tenant occupants an opportunity at home ownership. In 2007, the Watergate Hotel was to be converted to co-op after the neighborhood protested that a condominium conversion would allow too many investors. Slow sales and changing economics have tabled this conversion.

Co-ops will sometimes investigate the idea of going condo, which can create a larger market for the homes on resale. A conversion may require 80% approval, and some residents may have very valid reasons to vote against it. Current owners may worry about an influx of investors who rent out their units rather than occupy them. Another down-side of such a conversion is that long-time residents, and particularly those on fixed incomes, will see significantly higher tax bills. The District is very adept at adjusting the tax bills of neighboring condo units with resale data, while such data is not accumulated for stock and membership transfers.

How it Works

Most new construction in this country has some form of community association (condominium, cooperative, or home owner association). In cooperative homeownership, individuals buy shares in or membership into a corporation, rather than acquiring *real property* (synonymous with a deed). For tax purposes, in cooperative ownership, the corporation owns the building and there is only one deed for the entire building. Cooperative sales are not subject to the local transfer and recordation taxes on the sale of real property. One of the great benefits of home ownership is the same – the deductibility of interest on borrowed money.

Members/owners in the cooperative have exclusive rights to their particular unit through an occupancy agreement/proprietary lease with the cooperative corporation – often referred to as the cooperative ownership contract. With this contract, the owner agrees to comply with the cooperative's bylaws and to pay a monthly fee toward the operation and maintenance of the building along with the shareholder's pro-rated share of the real estate taxes. Depending on building amenities, this fee may also include heat, hot water, insurance, staff salaries and some or even all utilities.

Both co-ops and condos elect a board of directors who oversee operations and annual budgeting. This board manages the affairs of the corporation and may retain a professional management company to handle actual day-to-day management if permitted under their established bylaws.

The cooperative board of directors often reserves the right to interview and approve prospective purchasers for membership/ownership. The board approval process is perhaps the most significant operational difference between co-ops and other forms of ownership. Part of the co-op lore is that the review process was instituted to keep out “undesirable elements.” A famous case in point was *The*

Dakota in Manhattan, also home to musician/artist Yoko Ono, which denied Richard Nixon the purchase of a unit after he left office.

Today, the board review process is designed to educate the intended purchaser about the responsibilities of cooperative ownership and to review the purchaser's application package including financial information and letters of reference. The co-op board has the right to determine approved financing including required minimum down payments and minimum cash requirements. This can be done to determine if someone has the ability to assume an existing underlying or blanket mortgage or other assessment changes in the future. Also, co-ops must be purchased by individuals, and cannot be bought by a corporation or trust. Anonymity in a cooperative, therefore, is not possible. Co-op boards are governed by local Fair Housing regulations.

Benefits of Cooperative Ownership

1. Location – As with all real estate purchases, location is key. As co-ops took off between the 1920s and the 1960s, they are often found in unique, close-in locations near metro, shops and restaurants.
2. Lower closing costs - As purchasing a cooperative is a stock or membership transaction, the transfer and recordation taxes assessed in many jurisdictions on real estate sales do not apply. Further, title searches are handled through a less expensive Uniform Commercial Code (UCC) search. Closing fees for a co-op average less than 2% of purchase price. Closing fees for a condominium can approach 4% of the purchase price.
3. Easy ownership – In most Washington properties, the co-op fee includes taxes and often some or all of the utilities (heat, water, sewer and electric). As such, an owner can budget more closely their ownership costs on a monthly basis as many of these costs effectively become fixed.
4. Higher owner occupancy – While condominiums may appear to transfer more frequently or be rented more regularly, co-ops tend to be longer term purchases, not held by investors, nor occupied by large numbers of renters. This can foster more of a sense of community, particularly in the larger buildings.
5. Tax deductions - Like traditional financing, interest on share loans, the portion of the monthly co-op maintenance fee attributed to real estate taxes, and certain closing expenses may be tax deductible.
6. Improvements - Cooperatives have the ability to borrow funds for repairs and capital improvements. A debt of the cooperative is often referred to as an underlying or blanket mortgage. An underlying mortgage may also exist from the time the cooperative purchased the land and building. The interest paid on each cooperative members' pro rata share of the corporation's mortgage may be tax deductible.

Considerations - How do cooperatives vary from condominiums

Taxes and Fees - Co-op fees tend to appear higher than condo fees, but include many of the costs of home ownership – the pro-rata share of real estate taxes (often hundreds of dollars for condos), operating costs, and frequently some or all utilities. In weighing a particular co-op versus another property, ascertaining what is included in the fee is important to make an informed comparison. As should be expected, you will have higher fees in buildings with added services such as doormen, front desks, pools, and on-site management and maintenance. Also be aware that when taxes are listed for cooperatives in the multiple listing system, they are often stated for the entire building (as all units share one tax identification number) and can appear staggeringly out of whack with the sales price.

Review of Documents – Similar to condominiums, after contract ratification the purchaser reviews the organization's official documents and may rescind the contract at their sole discretion prior to the

expiration of the review period. The document review informs the new owner about the rules and regulations of the building and, most importantly, the overall financial strength of the building.

Board Approval – In most cooperatives, a potential purchaser must make an application for membership and submit to an in-person interview before a board committee. The goal of the interview and application process is to inform the applicants of the nature of cooperatives, the responsibilities of each member, the house rules, and to assess the financial ability of the applicant to meet the ongoing financial responsibilities of the cooperative.

Rental Restrictions – Cooperatives deter unit rentals, because higher rental ratios will change the tax status of the entire building. As such, co-ops often escalate their fees by up to 50% for those owners renting their units. As a general rule, most buildings require you to occupy the residence for two years and then rent for no longer than two years. At that point, the co-ops may require that the owner re-occupy the property or sell the property rather than rent it indefinitely. Rental applicants may also need to be approved by the cooperative board. If your long-term plans may include extended time out of the area, you should consider this difference carefully. Generally, most policies take into account State Department and military tours.

Settlement Costs – Settlement charges are lower for co-ops than for other forms of property as the sale is treated as the transfer of personal property (the stock certificate or cooperative ownership contract). As such, the transfer and recordation taxes on the sale of real property assessed in many jurisdictions do not apply. Further, title searches are handled through a less expensive UCC search rather than the various public records.

Different Financing – Co-op lenders are limited in comparison to condominiums. Only specific banks have recognition agreements with specific cooperatives. Co-op lenders typically require a down payment of 3% to 10%, although some co-op bylaws may require sellers to have a higher equity (15%, 20% and even a 50% building). By comparison, condominium loans for full value or even 103% financing are possible. In the last few years, many new lenders have established co-op recognition agreements to serve more potential purchasers.

Repairs and Maintenance – Due to their corporate structure, co-ops are able to borrow funds should it be necessary to finance any major repairs or capital improvements. The debt would then be incorporated into and serviced by the co-op fee or a supplemental portion of fee related to the underlying mortgage. Condos can resort only to special assessments if reserves are not adequate.

Underlying Mortgage – A co-op can have an underlying mortgage (also called a blanket mortgage) from either its initial inception or at some later juncture to cover capital improvement costs rather than by special assessment. A purchaser will assume the seller's pro-rata share of the underlying mortgage, which is typically included in the list price. The purchaser will then bring cash and/or obtain a share loan for the balance of the purchase price.

Parking – When parking is available, it can be secured by seniority, by lottery or by separate lease (less common). Owners generally have preference over renters.

Co-ops as a Green Alternative

One of the complaints made by some owners in older buildings is that many of the systems are controlled centrally. While you receive nearly unlimited hot water for your shower from a central reservoir, the radiator may be hard to fine tune. However, co-ops do take their bills for heating, cooling, water and other centralized services quite seriously. As such, the building may install larger capacity boilers, water heaters and water chillers that benefit everyone and are regularly serviced for peak performance. The efficiencies possible here are actually quite great. Many buildings have on-site maintenance staff who respond to leaky faucets and toilets because cumulative water savings can be significant. We have seen several buildings undertake the costly task of replacing all their old single pane windows with more energy efficient models – something that would less likely be coordinated in a condominium. Co-ops may come to represent a green alternative in the future.

Analysis

Over the last three years, co-ops have held a steady 12% share of Washington apartment sales in terms of both units and overall dollar volume. Similarly they currently represent 12% of the available active apartment listings. Average coop sales prices have risen on the same trajectory with condos, selling within 10% of typical condo prices which bring differences back to size, updates and amenities.

Market time, not readily comparable with condos from our data, has more than doubled over two years to 67 days, but the properties are realizing 97% of their final list price. The increase in hold time has also been seen in condos and houses.

The argument that buildings requiring larger down payments holds back prospective purchasers is moot. In truth, these tend to be the more upscale buildings where enough purchasers desire the amenities and location that the purchaser can put together the required working capital.

The real challenge for coop sales remains misconceptions to this form of home ownership.

What is Best for You?

Adequate numbers of purchasers with long-term plans do find this form of ownership attractive. The down payment requirements and restrictive rules about renting a unit may discourage some purchasers, but this market segment has remained healthy and robust relative to condominium sales.

Given that many cooperatives have larger floor plans, those in search of elbowroom may find cooperatives a greater value. As many buildings are older, and thus have older kitchens and baths, those purchasers willing to renovate may also be able to find a unit to tailor to their specific needs and not compromise on material selection and design. Renovation cost versus value added is the subject of another Melman and Molik report. Any hesitancy of potential purchasers just creates opportunities for informed consumers such as you.

(more)

Past sales data indicates that this form of ownership holds its value, and therefore should be a component of any home search. Please also refer to our co-op home report with analysis of nine years of sales.

Dan Melman and Mary Jane Molik

We make co-op non-believers into co-op owners!

Dan Melman and Mary Jane Molik at W.C. & A.N. Miller – A Long & Foster Co. are noted for their knowledgeable and thorough approach to real estate. Although not co-op owners themselves, the Melman and Molik team annually handle numerous co-op transactions and are well versed in the requirements of co-op listings. To reach them, please call 202.895.8950. Their email address is success@MelmanMolik.com and their website is www.MelmanMolik.com.

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