



Co-op Primer

Revised October 2010

When purchasing a home, most buyers have set their mind on a house (be it a detached home or a townhouse) or an apartment. The “apartment” term is often synonymous with condominiums. Missing from this lexicon is the cooperative apartment or “co-op.” Co-ops are a long established form of home ownership that pre-dates condominiums.

The concept of cooperatives is often a mystery, even to the savvy purchaser and sometimes even to the seasoned real estate agent. Cooperatives originated in New York, but now are often found in cities with large numbers of transplanted New Yorkers (urban areas in general and particularly Washington D.C., Chicago, and parts of Florida).

The District has more than 100 different cooperative buildings encompassing many thousands of individual homes. Therefore, overlooking cooperatives in your search for a Washington home limits a buyer’s options. Co-op buildings combine interesting histories, unique and varied architecture, sizable living areas, distinctive details, and sought-after locations. Many of the premier buildings in town, residences that are known by their name or street address, are co-ops – the Watergate, the Broadmoor, 2101 Connecticut Avenue, and The Westchester, to name a few.

My co-op primer is intended to highlight the nuances between co-op and condo ownership for the first time buyer as well as the experienced purchaser.

History of cooperatives in Washington

Co-ops arrived early in Washington. Two projects were formed when the groups of original owners bought land and developed a building. The Concord, built in 1891 at the corner of New Hampshire and Swann Streets NW was razed in 1962. 2852 Ontario Road NW was built in 1909 and still exists today. These were smaller projects in nature and preceded the boom period of the 1920s.

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 Allen E. Walker, 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 owners could “buy” their apartment homes. These early conversions were “stock” cooperatives – a stock certificate existed in addition to a proprietary lease on each unit.

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In 1928, the Parkway, a new construction project at 3220 Connecticut Avenue NW went bankrupt. The cooperative corporation was established when only 25 of the 83 units had been sold. The initial purchasers lost their downpayments and the courts later evicted 18 occupant/shareholders. The House of Representatives held hearings on the Parkway debacle, and as a result, the developer was arrested for fraud. The 25 shareholders were reprimanded for “capriciously investing in an unsound project.” New regulations were established after which cooperatives could not incorporate until 80% of the units had been sold, prior to which all deposits were to be held in escrow. Such regulations govern much of what happens with condominium conversions today.

In 1948, in order to avoid SEC requirements, the Boardmoor and Westmoreland cooperatives became membership cooperatives rather than stock cooperatives. 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.

Initially, purchasing a cooperative required either all cash or very significant cash down payments. In the late 1970s, financing the purchase of cooperatives became easier as banks began pilot loan programs for co-op resale using recognition agreements allowing the lender to hold a security interest in the borrower’s unit. Co-op mortgages are often referred to as share-loans – a loan for the purchase of shares of a corporation. By being able to “attach” to a security interest, lenders were able to provide more competitive terms. In the height of the market boom, loans of up to 90%, and sometimes even 95% were common. Revised conventional lending requirements now fund loans up to 85% and sometimes 90% of purchase price depending on loan size, credit and cash reserves. Interest rates for co-op loans are in sync with condominium interest rates, both of which are typically a fraction higher than fee simple loans. Some buildings, however, require even higher down payments for board approval.

How it works

Most people think of home ownership as “bricks, mortar and dirt” which is transferred with a deed. In cooperative homeownership, individuals buy shares in, or membership into, a corporation, rather than acquiring *real property*. For tax purposes, in cooperative ownership, the corporation owns the building and likely owns the land (or not, as the Watergate on a land lease). Two of the great financial benefits of home ownership are the same – the ability to borrow money and 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.

Purchasers are more often familiar with condominiums, which have succeeded in both urban and suburban centers. 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 – a combination of specific ownership meshed with a general interest in real property. The condominium concept was brought to DC in 1963. Condo ownership is evidenced by

a deed and a condominium rider. By comparison, shares in the co-op and an occupancy agreement evidence cooperative ownership.

Very similar for both co-ops and condos is that an elected board of residents/directors who oversee the daily operation and annual budget. This board manages the affairs of the corporation and may retain a professional management company if permitted under their established bylaws.

The cooperative board of residents/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.” Today, the process should be to educate the intended purchaser about the responsibilities of cooperative ownership and to review the application package. This application package can be quite detailed and typically includes financial information and letters of reference. Anonymity in a cooperative, therefore, is more difficult than with the purchase of a house or condo. When an ownership interest is sold, cooperative ownership records are reviewed by the Board or by the coop’s transfer agent, who confirm that the seller is a member in good standing.

Benefits of Cooperative Ownership

1. Location – As with all real estate purchases, nothing can compete with location. As co-ops took off between the 1920s and the 1960s, these buildings are often found in unique, close-in locations near metro, shops and restaurants.
2. Reduced closing costs – As purchasing a cooperative is a stock or membership transaction, title searches are handled through a less expensive UCC search rather than a more complicated title search in the land records. Effective October 2009, District co-ops are now subject to the same transfer and recordation costs that have been charged on condominium sales at closing.
3. Easy ownership – In most Washington properties, the co-op fee includes taxes and often some of the utilities (heat, water and sometimes electric). As such, an owner can budget more closely their ownership costs on a monthly basis as many of the costs 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 and not held by investors or occupied by 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. With further questions, consult your tax professional.
6. Building Maintenance – Cooperatives have the ability to borrow funds for repairs and capital improvements. A debt of the cooperative is often referred to as an underlying mortgage. An underlying mortgage may also exist from the time the cooperative purchased the land and building or to undertake a large maintenance project. The interest paid on each cooperative members’ pro rata share of the corporation’s mortgage or loan is tax deductible.

Considerations - How do cooperatives vary from condominiums

New for 2010 → Risk concentration – At one time, co-op boards tended to be concerned when investor ratios began to approach 50% because exceeding that threshold had negative tax consequences and disastrous financing consequences. All of those would then be reflected in co-op value. Many cautious

banks are now hesitant to lend in buildings with more than 20% investor concentrations. This change has challenged several large complexes and also hinders very small buildings too. Condo lending programs, and particularly FHA, are much more flexible. Lenders also now focus on how many loans they originate in a new co-op conversion. The lender will decline a loan if their share of loans in a building is too high – something that is not seen in the resale market.

Taxes and fees - Co-op fees tend to appear higher than condo fees. Co-op fees often include many of the costs of home ownership – the pro-rata share of real estate taxes, operating costs, and sometimes a portion of, or all of the utilities. In reviewing a particular co-op against another or a condo, ascertaining what is included in the fee is important to make an informed comparison. Foremost, cooperative real estate taxes are paid by the corporation. With a condo, each unit comprises a separate tax parcel and is assessed and billed separately. In older buildings, utilities such as the gas fired radiator heat, and in some instances even electricity may be included in the fee. As should be expected, buildings with added services such as doormen, front desks, pools, on-site management and maintenance will have higher fees. Determining what is included in the fee is also important. Also be aware that when taxes are listed for cooperatives in the multiple listing system, they are often stated for the entire building.

Approval of board – In most cooperatives, a potential purchaser must make an application for membership and be interviewed by a committee of the board. The goal of the interview and application is often 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.

Review of documents – Similar to condominiums, after ratification of a contract the purchaser reviews the official documents of the organization and may rescind the contract at their sole discretion prior to the expiration of the review period. The review of the documents is intended to inform the new owner about the rules and regulations of the building and, most importantly, the overall financial strength of the building.

Rental restrictions – Cooperatives are often more strict in deterring unit rentals. This is because higher rental ratios will change the tax status of the entire building or limit funding options. As such, co-ops often escalate their fees by up to 50% for those owners renting their units. Rental applicants may also need to be approved by the cooperative board. Co-ops typically require that the owner re-occupy the property after a determined number of years or sell the property rather than rent it indefinitely. 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.

Different financing – Not all lenders will make co-op loans, and not all loan programs will work with co-ops. As most lenders will provide a well-qualified buyer financing for a variety of different condo locations, only specific banks have recognition agreements with specific cooperatives. Co-op lenders typically require a down payment of 10% to 15%. Sometimes co-op bylaws may require sellers to have a higher equity stake in the co-op. By comparison, there are a wide variety of condominium loans available in the market today, including FHA financing up to 96.5% of purchase price. This program in particular favors buyers with good credit and earning potential, but little money to put down.

Prices – In DC, condominium and co-op prices actually peaked in 2005. In our current market, the typical co-op might sell at an average price 11% below the typical condominium. These ‘typical’ units may not be fair comparisons, as location, size and amenities can easily amount for such variations. The differential between co-op and condo pricing has been stable in the run up to 2005 and also down from the market peak. I attribute the difference in average price to the actual units rather than the form of ownership.

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. Condos can resort only to special assessments.

Underlying mortgage – A co-op can have an underlying mortgage (also called a blanket mortgage) from either its initial inception or some other repairs and renovation work. A purchaser will assume the seller’s pro-rata share of the underlying mortgage, which is typically included in the list price. There will be a separate payment to the co-op for this loan above and beyond the regular monthly co-op fee. The purchaser will then bring cash and/or get 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.

Analysis

Updated October 2010: Prices across the city may have peaked in 2005, but local prices have not cratered like much of the country. The change in the market is really seen in two components. First, the volume of sales has tracked down sharply from 2002, which had many more sales before prices began to skyrocket. Second, of the sales now and in the last few years, buyers have held sway – if not in overall pricing, at least in negotiating off of list price.

With marketing times now measured in months, proper pricing, exposure and the ability to explain the nuances of co-op ownership are crucial. The entry segment of the co-op market has been battered by the tighter financing terms (lack of FHA and higher down payment loans) and the change in closing costs associated with transfer and recordation taxes. The middle and upper markets, where co-ops are priced for their location and are purchased as a destination, should not be affected as strongly.

This form of ownership does hold its value and should be a component of any home search. At the moment, of the active apartments available for sale, 19% are coops.

Dan Melman

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

Dan Melman is an agent at W.C. & A.N. Miller – a Long & Foster Co. He is noted for his knowledgeable and thorough approach to real estate. Although not a co-op owner himself, Dan Melman handles numerous co-op transactions and is well versed in the requirements of co-op listings. To reach him, please call 202.841.8353. His email address is Dan.Melman@LongandFoster.com.

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