

Refinancing: Legal Aspects & Pitfalls

Attorneys Randall Pentiuk and Joe Couvreur, partners at Pentiuk, Couvreur & Kobiljak were recently invited to write an article on the legal aspects of Refinancing for the National Association of Housing Cooperatives. NAHC published an edited version of the article in its Cooperative Housing Bulletin. The full version of the article is published below, and contains timely advice for not just the refinancing process, but also how to deal with contractors hired to upgrade the property with the excess loan proceeds.

A large number of cooperatives are contemplating refinancing their existing mortgages. Several reasons exist for this. First, interest rates are at an uncommonly low level which makes it rather advantageous to take out a loan. While the existing mortgages are typically low, the rates now are extremely attractive and may not last much longer. Thus, there is a window open now to get great interest rates. Second, many cooperatives have experienced HUD being more burdensome in its demands than in the past. They seek to either eliminate or reduce HUD oversight by eliminating the mortgage which HUD insured or subsidized. A third and most common reason is the need to amass a sufficient sum of money to undertake repairs, renovations and enhancements of the property. Many cooperatives would prefer to complete these tasks in the near future to properly maintain the property rather than make improvements over an extended number of years.

The Players

Boards ask us what steps are involved. The initial step is to assemble a team to do the “due diligence,” research the options, and to handle the mechanics of taking the project through the steps outlined below, culminating in the closing. The Board, of course, must be involved as the ultimate decision-maker at all stages. Management and a Cooperative Attorney with expertise in dealing with the intricacies of this type of transaction and dealing with HUD are essential players who provide guidance and perform the task of carrying out the mechanics of putting the deal together must be involved. There may also be a need to consult with the Cooperative Auditor for financial projections and related services.

It is important that this team work closely together at every step of the journey. Typically, the Management Agent serves as the coordinator while the Attorney does the lion share of the detailed work of negotiating and preparing the detailed paperwork for the new loan and paying off the existing loan.

Early on, we must determine where the authority lies to borrow money. Most bylaws give that authority to the board. However, we do not recommend that the

membership be excluded from the process. HUD will request proof of membership notification. Information ought to be shared so the members know and understand what is being done and why. The most common question is what impact will this have on carrying charges, and you should have an answer. Many cooperatives have refinanced with no increase in carrying charges because of the low interest rates and the amount borrowed. Again, typical bylaws allow the board to decide such matters.

It should be noted here that HUD initially demanded a vote of the members. When challenged to point to the law or bylaw provision that mandated that, HUD backed off and simply requested evidence that the members had been informed. While we do not agree that HUD can require it, boards that we represent are encouraged to convene informational meetings for the membership at which time the plans are discussed, for reasons stated below.

Dealing with Membership

Holding informational meetings with the membership bring to the forefront a number of erroneous beliefs held by some. It is important to debunk these myths, and to do so with concrete answers. Otherwise, the rumor mill will run rampant and there will be a lot of confusion, controversy and dissension .

First, there are many members who hold the belief that they will somehow automatically own their units when the mortgage is discharged. This is simply false. The legal structure of the cooperative is unaltered, regardless of the mortgage. The member will still be a member on the morning after; and he or she will still have a proprietary lease (known as an occupancy agreement). The very same Board will run the Cooperative as the day before. .

This leads to the second myth. Many believe that the cooperative must take some action at the time the mortgage is paid off. Nothing is farther than the truth. Cooperatives are corporate entities, with perpetual existence. This means that they will continue on and on, forever. Therefore, no rush to take some action is needed.

We do not mean to imply that the board should not evaluate its options. As fiduciaries, Board members need to be ever vigilant and consider opportunities. But our point is that the Cooperative does not have to do something - rather, it may choose to do so. The difference lies between “must” and “may.”

So what does it mean to discharge the mortgage? Simply it is an end to payments to that particular lender, and either the elimination or reduction of HUD’s close oversight of the Cooperative through its Regulatory Agreement powers.

We recommend that the board undertake careful and deliberate study. It must be ready to debunk these myths. It needs to have answers for members who suddenly want to convert the cooperative into condominium units in an attempt to get rich quick. It needs to be prepared to discuss the various options and the consequences of each. It

ought to be ready to lead. and make decisions, while at the same time furnishing accurate, understandable information to the members. To do otherwise is an invitation to create a disgruntled membership.

The Due Diligence Stage

The next step is to see what rates are currently available. A quote should be requested from the National Cooperative Bank in Washington, D.C. But the inquiry should not stop there. Many lenders are interested in competing for your business and they should be asked to provide a proposal.

Once these are obtained, the board should get professional assistance in analyzing the proposals. It is not as simple as looking at the various interest rates, although that is an important component. Other issues include the amount of the closing costs and requirements demanded by the lenders. Lenders are not alike, and will take different positions on these matters.

We recommend that the board “short list” the lenders and negotiate with the lenders with the best two or three proposals. We have found a lot a flexibility and willingness to compete when this process is used. Do not accept proposals at face value. Try, instead, to press the lenders for better deals. Unless expertise exists on the board, this task should be done by the Management Agent and the Attorney. The Auditor or Accountant for the Cooperative has expertise that would be helpful at this stage.

Part of this process helps answer the question of how much to borrow. Obviously, the Board will borrow enough to pay off the underlying mortgage. How much beyond that will depend on a variety of factors such as interest rate, payment terms, the impact upon carrying charges, and the Cooperative’s needs for improvements. Careful study and research by the Board and its professionals is critical to making a proper decision on the loan amount.

In the event the Cooperative received a “Flexible Subsidy Loan,” it will need to be paid in full at the closing. However, there some rare exceptions to this rule for certain Cooperatives which fit the criteria for an extension of the so-called “Flex-Sub Loan.” Cooperatives which were originally occupied by low income members but are now largely occupied by over income families whose incomes have increased over the time are not likely candidates for flexible subsidy loan payment extensions. In the event approval to extend the loan is granted, the Cooperative will be subject to afford ability restrictions until the flexible Subsidy is paid in full. This is likely to be the term of the new mortgage.

Another form of subsidy is the “Interest Reduction Payment” which is provided to pay a portion of the interest component of the Cooperatives’ original financing. A Cooperative which receives a IRP subsidy should seek approval to “decouple” the interest reduction payment from the loan which is being paid off and transfer it to the new loan. The “decoupling” process is lengthy but is well worth the effort to insure this

form of funding is not forfeited due to the refinancing. Here again, the Board should obtain the expertise of a Cooperative Attorney with experience in such issues.

The Mechanics of Closing

Once a selection is made, the lender will issue a formal letter of commitment. This outlines the entire deal and the requirements of the lender. The Management Agent and Attorney should be charged with handling these tasks. Among them is securing a full survey of the property, getting a special type of title commitment, clearing up any clouds that may be in the cooperative's chain of title, and providing the lender with financial and other records. The existing lender must provide a payoff letter. HUD needs to approve of the refinancing, and in the event HUD services the loan, HUD will provide payoff letters.

Occasionally, the title search will reveal a problem with the chain of title. We have found parcels of land which were not conveyed to the cooperative, stray deeds, mistakes in legal descriptions and liens that no one knew about. Some of these problems can be easily cured; others may require litigation to clear up. These issues can be time consuming, so we recommend that this step be undertaken as early as possible. Some lenders will lock in the interest rate for a period of time while these problems are addressed.

With respect to HUD, a full discharge and release of the Regulatory Agreement should be obtained. In the case of limited equity cooperatives, such as 221(d)(3)'s, HUD will require a new deal known as a Use Agreement. The Use Agreement is a scaled down version of the Regulatory Agreement that does not contain all of the numerous conditions and terms you are accustomed to, but does require the cooperative to remain affordable housing for the balance of the term of the Regulatory Agreement. Those who paid off early encountered some difficulty in dealing with HUD on this document, and there were different directions given by HUD in Washington and HUD's local offices. This seems to be getting better, but you should allow for sufficient time to handle this negotiation. This is best handled by the Attorney for the Cooperative.

It should be noted that the new lender will require certain terms in the deal. Among them is the mandate that the corporation remain in its present form. This means that converting to condominium will not be an option as long as the loan is in effect. The Cooperative will have to stay as a Cooperative. Similarly, the lender will want to make sure that professional management remains intact and will want to approve any changes in this regard. A prepayment penalty may be sought as well as mandating that the Board keep a certain level of funds available in reserve for emergencies. Certain levels of property and liability insurance will be required to protect the collateral. It may also require an annual inspection of the property to ensure that it is being properly maintained.

When all these prerequisites are fulfilled and the terms are negotiated to a successful conclusion, the closing will take place and the loan proceeds will be dispersed. From the loan proceeds, the existing mortgage will be paid off and a discharge will be obtained from that lender, which needs to be recorded with the registrar of deeds. The Regulatory Agreement needs to be released and recorded. The Cooperative Attorney handles these details.

Post Closing

Once HUD oversight is eliminated, a number of opportunities exist. The Cooperative may want to amend its governing documents to remove references to HUD and the Regulatory Agreement. While doing so, you may also want to clear up nagging problems such as quorum issues, as well as liberalize the manner in which voting takes place - such as absentee ballots, day-long voting and the like. Where the law has changed and made bylaw provisions obsolete, such as in the limited proxy area, you may want to take advantage of the opportunity to clean up such matters. The Cooperative Attorney needs to be involved in these issues.

If the cooperative is going to undertake repairs or renovations with what money is left over, you need to seek proposals from various contractors. Before that can be done, the Board must determine with some degree of specificity what it wants to accomplish and develop specifications that are written and sent out to a number of contractors. Proposals should be sought, a "short list" derived by the Board and negotiations should be undertaken to get the best deal possible. Your Management Agent should take the lead in this process. Once that is done, the Attorney needs to prepare a contract to protect the Cooperative. Make sure that there is adequate insurance and indemnifications, that there are warranties, and consider including liquidated damages for delayed performance and perhaps a bonus for early completion.

Depending upon the magnitude of the project, it may be desirable to engage a construction manager to coordinate the contractors and deal with such issues as partial payments and subcontractor issues. Of course, this adds to the expense but may be merited if you are going to have numerous contractors engaged instead of just a single one. Perhaps your Management Agent is experienced in this role and can provide assistance.

It is important to pay close attention to the state construction lien laws. These are designed to protect suppliers and subcontractors from being cheated by the general contractor, and there are some strict rules that must be followed. Never pay a general contractor unless there is sworn statements and lien waivers from those who provided materials or services to the project; failure to observe the rules can lead to paying the general contractor and then having the subcontractors and suppliers coming to the Cooperative for payment a second time. They have the right to file a lien on the Cooperative property and enforce their rights to payment by foreclosing on the property.

Thus, this aspect cannot be overlooked and do not assume that the Management Agent necessarily possesses the requisite knowledge to understand the statutory requirements. Consult with an experienced Cooperative Attorney to be safe.

Conclusion

In sum, refinancing is an option that is worthwhile examining to see if it makes sense to your Cooperative. The analysis should be done now while we still have relatively good interest rates. A team approach including the Board, Management and the Attorney, will ensure that it is done properly and in good order. It is not a quick process but if experienced professionals are used, it can be expedited. Once it is complete, it opens up a wide range of opportunities for the Cooperative to move forward into the future with less or no oversight from HUD, and typically with enough money to make the Cooperative appearance compete better with other housing stock, leading to less vacancies and greater pride among the membership.

List of Refinanced Michigan Cooperatives

The following is a list of Cooperatives that we have assisted in their refinancings or mortgage payoffs. Of interest is the variety of issues dealt with, such as flex sub loans, section 8 contracts, interest reduction payments, use agreements, and MSHDA loans.

[insert list that Lori Syc prepared - only take out the Coop name and insert the City of the Coop]

News You Can Use

*** LEP is closer than you think.** LEP stands for Limited English Proficiency.

During the Clinton Administration, an Executive Order was signed that directed federal agencies to require translation of english documents into foreign languages. As applied to Cooperatives, if just one member is not proficient in the english language but speaks any of seven major foreign languages, you will be forced to translate - at Coop expense - all of your essential documents. And the Department of Justice is starting up enforcement of this mandate.

It is unknown the extent of the documents that will be the subject of the translations, but it is likely to be all of the governing documents such as the Articles of Incorporation, the Bylaws, the Occupancy Agreement, the Coop's Rules, as well as Meeting Notices and Minutes. The NAHC is joining other groups to lobby that the federal government pay for this service rather than impose it upon the Cooperative. Mr. Pentiuik serves on the NAHC Board of Directors and its Government Relations Committee, and will be monitoring this subject and the efforts to change the payment requirement.

*** MAHC Conference in San Diego this May.** If you have not already made plans, contact the MAHC office to register for what is slated to be the best ever conference put on by MAHC. Randall Pentiuik will be presenting classes there on Bylaw Amendments and his annual Legal Update course. Some lavish receptions and a cruise are being planned.

*** NAHC Conference in Miami this September.** Plans are underway for the annual NAHC conference, being held in sunny Florida this fall. Check the NAHC website for more details.

Web Resources

Here are some websites you may wish to check out. They all relate to Cooperatives.

The Michigan Cooperative Law Center at www.michcooplaw.com contains articles and seminar materials that you will find useful. Sponsored by Pentiuik Couvreur & Kobiljak as a free service to Cooperative Board Members, it now lists all the housing cooperatives in Michigan that we know about, and links to those which maintain websites.

If your cooperative is not listed or is not linked to this website, please contact us. It also has an on-line version of the popular "Michigan Cooperative Law Primer" written by Mr. Pentiuik. (Note: copies of the printed version are available at no cost by contacting us).

MAHC's website at www.mahc.coop is a source for regional news and announcements. It has some resources that you may find helpful, including Requests for Proposals for Management Services.

Similarly, the National Association of Housing Cooperative also has a rather useful website available at www.coophousing.org It has a wealth of good information, including a lexicon of cooperative terminology.

HUD also has a good website at www.hud.gov.

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