Alternative Sources To Increase Reserve Funds For Co-ops

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There are three primary sources for co-ops to increase their reserve fund for upcoming capital improvements:

1. Refinance the underlying mortgage (or obtain a second mortgage)
2. Impose an assessment on the shareholders
3. Flip tax

Options two and three do not generate a large amount of capital over a short period of time. Therefore, when co-ops need to raise capital quickly, they usually opt to refinance their underlying mortgage or obtain a second mortgage. However, refinancing the underlying mortgage can be cost prohibitive because underlying mortgages often require an onerous prepayment penalty.

If a co-op needs to replace a roof, boiler, or has an emergency repair without sufficient capital in the reserve fund, the only viable alternatives are to obtain a second mortgage, or line of credit, or impose a large assessment on the shareholders. In today's difficult economic times, these options can be very expensive or unaffordable for shareholders.

An alternative that co-ops should explore is amending the proprietary lease and bylaws to permit the Board of Directors to exercise a Right of First Refusal (ROFR) if an apartment is being sold at a price that is significantly below market value. In properties managed by Mark Greenberg Real Estate, we have seen instances in both strong and weak real estate markets when apartments are sold at significant discounts.

Co-ops that have exercised their ROFR have made profits of $50,000 to $200,000 when the apartment is resold at market value. These profits enhance the reserve fund and reduce the amount to be financed or assessed in order to pay for upcoming capital improvements. In addition, the profits that are realized from the sale of the units are tax-free to the co-op.

In order for a co-op to institute a ROFR, the shareholders need to approve an amendment to the Proprietary Lease and bylaws. This allows a board to purchase an apartment that is being sold at below-market value. The ROFR provision is in the bylaws of every condominium, but it is rarely in a co-op. The question of why an apartment would be sold at a below-market price is often asked.

There are many reasons why apartments are sold at steep discounts. The reason can be a divorce, a job transfer, an estate, a foreclosure, or something else, but it happens all the time. A 900-unit garden complex in Queens has exercised its ROFR at least once a year the past five years and has made an aggregate profit of over $200,000 from these sales.

A 150-unit co-op in Manhattan exercised its ROFR when a neighbor tried to buy apartment next door to increase the size of his apartment. The board exercised its ROFR, and after a lot of yelling and screaming and threats of litigation, the buyer paid the co-op $75,000 for waiving the right to buy the apartment.

If the shareholders do not want to amend the corporate documents, then the board can reject the below-market sale based on price. It is extremely unlikely that the seller will sue the co-op because there are no damages sustained by the seller if the co-op purchases the apartment for the same terms that the seller was going to realize in the original sales contract.

However, before any sale is rejected due to price, the board should consult with the attorney for advice regarding how the matter should be handled.

Co-ops managed by Mark Greenberg Real Estate over the past 10 years have increased their reserve funds by around $2,000,000 by buying and selling apartments. The board must be very careful because it is not comprised of real estate experts and has a tendency to micromanage the purchase and sales process.

The board needs to rely on the attorney, accountant, and managing agent to determine when it is the right price and the right circumstances to take advantage of this opportunity. A board should not buy an apartment to make a nominal profit. There is too much risk for a small amount of profit. But opportunities are often presented when a board can make $50,000 or more in profit and save the shareholders the possibility of an assessment for capital improvements.

The board has access to more information about apartments in distress than any prospective purchaser. Information is paramount to taking advantage of these opportunities. The board will know if the apartment is occupied or empty. The board will know if a rent-controlled tenant occupies the apartment. The board will know if there is a family dispute or an estate. The board is likely to know if there is a shareholder who has lost his job and is desperate to sell the apartment.

These are great opportunities for the board to enhance the reserve fund without taxing the shareholders. A good board with a good managing agent will take advantage of these opportunities.

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