STATE OF NEW YORK DEPARTMENT OF LAW

OFFICE OF ATTORNEY GENERAL ROBERT ABRAMS

MEMORANDUM

TO: REF Attorneys and Legal Assistants

DATE: 3/13/86

FROM: Mary Sabatini DiStephan/Nancy Kramer

RE: Leasehold Cooperative Plans

It is extremely important that we review leasehold cooperative plans in a consistent and fair manner.

You will recognize a leasehold plan from the typical statement on its cover that it is an "offering plan of leasehold premises". It will also refer in its introduction to a "contract to purchase a leasehold interest under a ground lease", and it may make index reference to a "ground lease" indicating that a fuller discussion of the lease terms is in the body of the plan.

Leasehold cooperatives are not per se illegal under New York Law. However, they often involve unusual risks that must be adequately disclosed. We have taken the position in litigation (1230 Park Avenue) that some plans are so inherently deceptive that they violate the Martin Act and are unconscionable within the meaning of Section 63(12) of the Executive Law and other laws.

In reviewing leasehold cooperative plans you should consider the following facts:

1. Is it an occupied building?

If there are tenants in the building, their options in deciding whether to purchase are far more limited than those facing outside purchasers. This is true whether it is an eviction or a non-eviction plan. (See point 2 below.) Leasehold cooperative plans for tenanted buildings should be scrutinized most carefully.

2. Will the cooperative corporation be able to obtain conventional mortgage financing?

This will be determined largely by the terms of the underlying ground or net lease, which should be reviewed with great care. If conventional mortgage financing may not be available to the cooperative corporation, the plan may be objectionable under the Martin Act and Executive Law Section 63(12). This is especially true if the building is older, is likely to involve considerable expense to maintain and repair, and the reserve fund is not adequate to meet any such contingency. These factors increase the possibility of default by the cooperative corporation, especially if the co-op

owes a duty to the fee owner under the ground lease to maintain and repair the building. The combination of factors may lead to the conclusion that tenant shareholders will have neither the means nor the incentive to maintain or improve the building -- this flies in the face of the policy underlying the cooperative conversion law.

3. What will be the disposition of insurance proceeds in the event of the total or partial destruction of the building?

The plan must be carefully examined to determined whether the cooperative corporation can use the proceeds to repair or replace the building. If the insurance money goes to the fee owner who can retain it, a major problem exists.

4. Was the leasehold all that the owner had to convey?

If the owner possessed a fee simple but created the leasehold to effect the co-op conversion, it may indicate unconscionable overreaching on the part of the sponsor. We should make every effort to discourage this type of carve-out by owners contemplating a co-op.

These are a few of the most important factors that should be considered in reviewing leasehold co-op plans. Undoubtedly there are many other important issues to be considered on a case by case basis. (See attached questionnaire.) Bernie Polak is very experienced in this area and, as in other areas, is a good source of information and advice.

The attached questionnaire should be answered by all sponsor's attorneys who submit a leasehold cooperative. These forms are available from the Public Information Office.

MSD/NK:dm

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QUESTIONNAIRE ON LEASEHOLD COOPERATIVE OFFERING PLANS

All offering plans which purport to convey a leasehold interest to the Apartment Corporation must contain adequate disclosure to answer each of the following questions. Please indicate on this questionnaire the page number in the plan where such disclosure is made, cross-referencing the pages to the lease or mortgage where applicable.

A. LEASEHOLD - TERMS OF THE GROUND LEASE.

1. **When was the original leasehold created?**

2. **What is the chain of assignment of the leasehold from the original ground lessee to the sponsor? Indicate date of each assignment.**

3. **Is the sponsor related to the fee owner (the ground lessor) or the original ground lessee?**

4. **Can the present lessee trace ownership of the building on leased land back to construction of the building?**

5. **If the answer to question 4 is no, how does the present lessee justify ownership of the building for real estate tax purposes? See Rev. Rul. 62-178. 1962-2 Cum. Bul. 91; Rev. Rul. 62-177, 1962-2, Cum. Bul. 89.**

6. **What are the major obligations of the ground lessee? (These would be the obligations assumed by the Apartment Corporation as the ground lessee.) Discuss obligations to maintain and repair, to pay rent, taxes and other charges, to keep premises insured to comply with all applicable laws, etc.**

7. **What are the material terms of default under the ground lease?**

8. **Are there any restrictions against the ground lessee making any structural or non-structural alterations? Whose consents are required?**

9. **Is there a non-disturbance clause which allows lease to survive a foreclosure on fee mortgage(s), bankruptcy of the fee owner or other proceedings by lien judgment holders or taxing authorities? If not, does the ground lessee have the right to make payments in default and be subrogated to the rights of the lienor?**

10. **Does the lease provide for survival in the event of substantial destruction and provide a right to rebuild? What is the disposition of insurance proceeds in the event of destruction? Does the insurance budgeted in Schedule B meet the requirements of the lease?**

11. **Does condemnation clause result in compensation to the leaseholder and no unjust enrichment to the fee holder?**

12. **Does the ground lessee have an option to purchase the fee or a right of first refusal? What are the terms?**

13. **Can the lease be renewed and if so, on what terms? Are there conditions to the renewal option so as to jeopardize the possibility of exercising the option to renew?**

14. **Is the wasting assest nature of the leasehold discussed in the special risk section and in the financial features section?**

15. **If any space covered by the lease is carved out by the sponsor (for example, commercial space), is there a reciprocal agreement detailing the relationship between the carved out space and the remaining space? Are the terms of such agreement reasonable? Does the carve-out result in an 80/20 problem under IRC Section 216 because of the income generated by the carved out space? See Alstores Realty Corporation, 46 T.C. 363 (1966), acq. 1967-2 C.B. 1; and Rev. Rul. 77-413, 1977-2 C.B. 298.**

B. LEASEHOLD MORTGAGES

16. **Does the plan disclose the terms of each leasehold mortgage in compliance with 13 N.Y.C.R.R. Section 18.3(s)? Include mortgages which will be assumed by the Apartment Corporation and any proposed new leasehold mortgages to be placed on the building when the lease is assigned to the Apartment Corporation. Disclose any relationship between the leasehold mortgagee and the sponsor.**

17. **Could the Apartment Corporation secure additional leasehold mortgages so as to refinance the existing mortgages or to fund repairs, replacements, improvements or reconstruction of the building? Discuss any restrictions on such refinancing. Would such financing be available from conventional mortgage financing sources?**

C. FEE MORTGAGES

18. **Does the plan disclose the terms of each mortgage on the fee in compliance with 13 N.Y.C.R.R. Section 18.3(s)? Disclose any relationship between the fee mortgagee and the sponsor.**

19. **Would all fee mortgages and any replacement or extensions of such mortgages be subordinate to a refinancing by the Apartment Corporation to fund repairs or replacements or reconstruction of the building?**

20. **Could the assignment of the leasehold to the Apartment Corporation trigger a due on sale clause in a fee mortgage?**

All submissions of the offering plans which purport to convey a leasehold interest to the Apartment Corporation should include the following documents in the Exhibit B binder.

1. **Ground Lease.**
2. **All existing and proposed leasehold mortgages.**
3. **All existing and proposed fee mortgages.**
4. **Title report which must be in an appropriate form to insure Apartment Corporation's prospective status as an assignee of the lessee under the ground lease.**
5. **Agreement to Assign Lease.**