Capital Funding and the Law

Funding the Big Fixes

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From time to time, every co-op or condo community has to undertake big capital improvement projects—perhaps a total window replacement, roof repairs, an elevator overhaul, or major exterior renovations.

The laws and regulations that deal with these processes—as well as the building's own bylaws— are often confusing. There are also plenty of steps to take before you can even begin work, such as dealing with contractors, architects and city bureaucracy, not to mention accountants and attorneys. Sometimes you'll have enough money in your reserve funds to cover these items, but at other times, you will need financing.

What Counts as Capital?

To begin with, what kinds of projects qualify as capital improvements? Most board members know, or believe they know, the difference between capital budget items and operating budget items. But there are several, although overlapping, ways of looking at this.

Attorney Lisa Smith, a partner with the law firm of Smith Gambrell & Russell LLP in Manhattan, quotes the definition used by the New York State Department of Taxation and Finance, which states that a capital improvement must "substantially add to the value of the real property or prolong its life; it becomes part of the real property or is permanently affixed to the real property so that removal would cause material damage to the property itself; and is intended to become a permanent installation."

Sandy Adelsberg, a sales and leasing agent at Veritas Property Management in Manhattan, approaches the question from more of an accounting point of view, and says that the Common Interest Realty Association (CIRA) Guide defines capital expenditures as "funds expended for improvement or major repairs of common property components that extend their useful lives or service periods."

Using an automotive analogy to illustrate, Adelsberg says that adding a turbo charger, heavy-duty shocks, or overhauling the engine of your car would be comparable to capital improvements in a building, while fixing a flat tire, which "merely restores the status quo," is not.

Attorney James W. Glatthaar, a partner at Bleakey Platt & Schmidt, a law firm in White Plains, further breaks capital improvements down into two categories: new items that did not previously exist (such as a new parking lot),and replacement of structural components that normally have a long life (such as a roof, boiler or windows). "Also," he says, "capital projects will be made only to or on common areas of the co-op or condominium."

Loan, Tax Implications

What impact does this all have on tax implications or loan rates? Are there points in favor of, and points against, classifying a project as a capital improvement, presuming there's some leeway?

Capital improvements are generally planned for—but not budgeted in—a particular budget year. If you classify a project as a repair, it will be included as an expense in a particular year.

Smith says that the main advantage to writing off something like a new roof as an expense rather than a capital improvement is to decrease the amount of taxable income for that fiscal year. Adelsberg, on the other hand, says that "classifying an expenditure as a capital improvement can save a co-op money on its federal, state and city corporation taxes," although it's not a big factor for condos.

Loans are not always needed; as we've mentioned, capital projects are frequently paid from a co-op or condominium's reserve accounts (although repairs and maintenance are generally paid from the development's operating accounts).

As far as paying interest is concerned, Barry Korn, CFA, managing director of Barrett Capital Corporation in New York City, differentiates between co-ops and condos. In a co-op corporation, he says "The corporation borrows, based on its owning the real estate, through a mortgage known as an underlying mortgage. In a condominium, the real estate is owned individually by the unit owner, and the corporation borrows on a pledge of its common charges, which is junior to the unit owner's mortgage."

Thus, he says, the direct real estate of the cooperative is considered stronger than the condo association's receivable as collateral, and as a result, interest rates for co-op corporations are lower than for condo associations.

Laws and Bylaws

As in any financial matter, knowing the law is also important. In a co-op, under the Business Corporation Law the board is responsible for financial affairs. This includes the responsibility to fund capital projects and manage the co-op's common areas, which includes replacements of the roof, boilers windows and so forth.

Similarly, says Glatthaar, New York’s Real Property Law imposes identical responsibilities on a condo’s board of managers. Neither law, however, establishes a threshold on what can be considered a capital improvement. For condos, the bylaws often mandate that unit-owner approval is required for any capital improvement exceeding a threshold amount. Bylaws of cooperatives rarely contain similar restrictions, he says.

While the Business Corporation Law (BCL) doesn’t contain any limits on how much money can be spent, Frank Korzekwinski, a senior vice president and the chief of real estate lending for Flushing Financial Corporation and its subsidiary, Flushing Bank, explains that it “it is a prudent practice to obtain competitive bids on capital improvement projects,” since the board could be questioned about the project’s scope or cost.

Smith adds that limits on borrowing are sometimes provided in a condo’s bylaws and, in the case of co-ops, in the bylaws and/or certificate of incorporation.

Co-ops vs. Condos

Are there differences between the ways condos and co-ops handle capital projects, in addition to what we’ve already mentioned?

Smith gives one difference. Because accountants use the term “capital improvement” to spread the cost of an improvement over time (i.e., over more than one tax year), co-ops will often designate a large repair or improvement project a capital improvement. However, she explains, because condos tend to pay for capital improvement projects with unit owner assessments, they often categorize such a project as an 'expense' on their taxes.

As we’ve mentioned, condo bylaws are generally more restrictive in requiring a majority or super-majority of the unit owners to approve a capital expenditure above the amount specified in the bylaws. “By comparison, the business judgment rule gives the board of directors of a cooperative corporation more flexibility, says Korn. “There are also differences in the loan documents that need to be reviewed.”

Lending Criteria

What criteria and/or documentation do lenders usually require from co-ops or condos to fund a major capital improvement?

Glatthaar spells out the documentation requirements: When asked to fund a specific capital project, lenders will require, at minimum, a copy of the contract with the general contractor of project manager and a copy of any permits needed to begin the projects. The lender may also require a copy of the plans and specifications, a review of these plans and specifications by an architect or engineer, an attorney’s opinion, and copies of all permits that may be required, “along with a final sign-off by the Building Department or Final Certificate of Occupancy.”

The loan will usually be granted to the building’s reserve account, which in turn will pay for the costs of the capital improvement project. “As long as the loan-value ratio is strong and there is value in the building itself, the lender will not be involved in the implementation of the borrowed funds,” says Smith.

And, as would be expected, a positive cash budget in a co-op or condo building/development will make a project more attractive to the lender.

One interesting observation from the lender’s point of view is given by Harley Seligman, vice president of National Cooperative Bank, which provides financial services to housing cooperatives, condominiums and other cooperative institutions nationwide “With condos, we loan the exact amount. We give co-ops a little cushion because they usually have a 10-year mortgage, and there is so much time involved, that the roof may be leaking two years from now [meaning that that another, unexpected project may be necessary],” he said.

Who’s on the Team?

Now that the project has been formulated, what is the role of the property manager? What about the board? How about the role of other professionals?

Seligman says that the person his company meets with varies from one building to another. “Some property managers are very good with handling property improvement projects. But many boards say, `We have an architect, we have an attorney on the board who can handle these matters.’

“It depends on the building. It can be an attorney, a broker, a manager. Some boards handle themselves.” Seligman personally likes to work with an experienced managing agent who might handle 50 buildings, and thus knows the ins-and-outs of the process.

No matter who meets with the lender, the process starts with the board. “Once the board votes to move forward with a capital project, and has consulted with the building’s accountant as how to best finance it, it is really taking a supervisory role by overseeing the managing agent, architect/engineer and contractors, who are charged with executing the board’s plan and performing the work,” says Smith.

Once the work is under way, she continues, planning and communication between the board, the professional team and the shareholder/unit owners is crucial. “Providing them with advance notice prior to the commencement of the project and updates along the way, will help ease tensions, especially if the project runs over budget, exceeds the scheduled time frame and /or if access is required in or through individuals’ apartment/units,” she says.

Korn recommends that the board bring in a firm that can function as the building’s overall construction manager. He gives one water filtration project as an example. “The board agreed to replace the roof, but when I did the site visit with the bank, it became clear that the building had to address water infiltration from the walls and windows. As a result, we increased the amount of the loan and brought in a construction manager,” he recalls. Korn also says that a good financial advisor or broker can often obtain a better rate from the same bank than would otherwise be the case.

Where to Go for More Information

The experts we interviewed for this article gave several options for boards to get more information on this subject. One is to obtain advanced, long-range capital planning. Many larger management companies will do this for their properties. This will make planning and budgeting easier and will make lenders more likely to give loans to the building.

Consultants, managing agents, attorneys, engineers, architects and accountants also can give valuable input. Accountants, in particular, know the importance of maintaining the building's physical plant and equipment—which, of course, keeps costs down.

Other resources include articles in The Cooperator itself; Ronda Kaysen's "Ask Real Estate" column in the Sunday Times; and continuing education courses offered by companies such as Lorman Education Services, the National Business Institute and others. Several New York City-based accounting firms like Czarnowski & Beer and Wilkin & Guttenplan also offer webinars and continuing education sessions. And let's not forget The Cooperator's yearly trade expos!

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