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COOPERATIVE APARTMENTS AND THE UCC

While the concept of a stock cooperative apartment corporation is not new, it did not gain popularity in the United States until World War II.[1] Several factors share responsibility for the growth of this concept.[2] For many people one factor was the desire to own their dwellings without the burdens normally attached to home ownership. Another was the security evidenced by having a home in a socially desirable environment where land was not available for purchase or where high cost made such a purchase impractical.[3] Since the Second World War, growing urban populations have created housing shortages, especially for the lower and middle income families. The financial support of the Federal Housing Administration[4] to promoters has benefited these income groups and together with favorable income tax regulations[5] has stimulated continuing interest in this concept of housing.[6]

The creation of a cooperative has usually been in one of three forms,[7] the most popular of which is the corporate-proprietary lease form. Here, a stock corporation is organized to obtain or construct an apartment

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[1]Cooperatives apparently made an appearance in New York in the latter part of the nineteenth century. At least the first known litigation was the case of Barrington Apt. Ass'n v. Watson, 38 Hun 545 (N.Y. Sup. Ct. 1886) which involved the validity of restrictions on assignments of a lease from a sublessee to a third person.

[2]For history and background of the development of cooperative apartments see Isaacs, *History and Development of the Co-operative Apartment*, 5 PRAC. LAW., Nov., 1959, at 62; Miller, *Cooperative Apartments: Real Estate or Securities?*, 45 BOS. U.L. REV. 465 (1965).

[3]Whitebook, *The Cooperative Apartment*, 9 PRAC. LAW., Apr., 1963, at 25.

[4]National Housing Act, 12 U.S.C. § 1715e (1970). This section extended the authority of the F.H.A. to permit the insurance of mortgages on cooperative apartment buildings.

[5]For a list of applicable tax sections see note 12 *infra*.

[6]Cooperatives should not be confused with condominiums, for while the general purpose of each is similar their character from a legal viewpoint is quite different. For detailed discussions on condominiums see D. CLURMAN & E. HEBARD, CONDOMINIUMS AND COOPERATIVES (1970); MacEllven & Eagen, *Condominium—A Symposium*, 41 TITLE NEWS, Dec., 1962, at 28; Comment, *Community Apartments: Condominium or Stock Cooperative?*, 50 CAL. L. REV. 299 (1962).

[7]4A POWELL ON REAL PROPERTY ¶¶ 633.2-.4 (1971). (1) The co-ownership plan is designed so that all tenants own the entire premises as co-owners in fee simple as joint tenants or as tenants in common with exclusive occupancy rights to a specific apartment. This plan is seldom used and is impractical, for the joint tenancy has the disadvantage of requiring a conveyance to all grantees simultaneously by means of a single instrument. Further, on the death of one tenant, his interest inures to the other joint tenants. In the tenancy in common plan there is the disadvantage of unlimited liability for any obligations incurred in the maintenance or use of the building. (2) The trust form of organization is feasible but seldom used, the greatest disadvantage being that the control of the enterprise must be vested in trustees. (3) The corporate-proprietary lease form is discussed in the text.

building which is to be operated on a cooperative basis. The corporation, holding title to all the premises, determines the value of each apartment and allocates the number of shares of stock in proportion to that value. A prospective tenant makes a stock purchase which entitles him to a proprietary lease.[8] The proprietary lease is similar to an ordinary apartment lease, but differs in several respects, the most obvious one being that no rent is specified.[9] The purchaser usually considers that he is buying a house, but all he has is the corporation stock and a lease. It is this dual purpose concept—a purchase of corporate stock and a purchase of a proprietary lease—that has troubled those courts seeking to classify cooperative apartment stock.[10]

This difficulty has been complicated by the fact that the cooperatives have gained popularity only recently, and accordingly there is a paucity of law on the subject. Those cases which have been decided are inconsistent in applying the law to the tenant-stockholder. Indeed, his character, when before a court, seems to take on a chameleonic quality and changes to satisfy the controversy under consideration. For example, in the New York case of *Lacaille v. Feldman*[11] the stock was classified as realty rather than personalty to determine the priority for attachment of a tax lien,[12]

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[8]Susskind v. 1136 Tenants Corp., 43 Misc. 2d 588, 251 N.Y.S.2d 321 (Civ. Ct. 1964).

[9]Whitebook, *supra* note 3. The "rent" is in the form of a maintenance charge fixed by the board of directors upon the basis of an estimate of the corporation's cost requirements divided into the total number of issued and outstanding shares, reduced to a per share figure, and payable monthly. In his article, Mr. Whitebook refers to other terms which may differ, such as restrictions on transfer of interest, an unusually long term (40 or 50 years) with a right of renewal, repairs to the interior being the responsibility of the tenant, restrictions on sublessees, an escape clause, provision for removing an objectionable tenant, removal of fixtures, mortgage, and provisions for amendment of the lease.

[10]Silverman v. Alcoa Plaza Associates, 37 App. Div. 2d 166, 323 N.Y.S.2d 39 (1971).

[11]44 Misc. 2d 370, 253 N.Y.S.2d 937 (Sup. Ct. 1964).

[12]For other cases holding that cooperative stock has the character of realty *see, e.g., In re* Pitts' Estate, 218 Cal. 184, 22 P.2d 694 (1933) (corporation held not to have proper lien against lease of deceased tenant-owner; the court said it was not concerned with the designation given the instrument, but must look to the substance thereof, which was realty); Curtis v. LeMay, 186 Misc. 853, 60 N.Y.S.2d 768 (N.Y. Mun. Ct. 1945) (stockholder given status of landlord in suit to evict another from apartment represented by stock and lease he had purchased); Justus v. Bowers, 167 Ohio St. 384, 148 N.E.2d 917 (1958) (stock held realty rather than personalty for purposes of taxation).

In criminal cases a sale of the stock has been considered as the sale of realty and not subject to securities regulation. Willmont v. Tellone, 137 So. 2d 610 (Fla. Dist. Ct. App. 1962); State v. Silberberg, 166 Ohio St. 101, 139 N.E.2d 342 (1956).

The Internal Revenue Service has generally treated the ownership of the stock and lease as realty as evidenced by the following code sections: INT. REV. CODE OF 1954, § 2515(a) [hereinafter cited as I.R.C.] (*see* Rev. Rul. 66-40, 1966-1 *Cum. Bull.* 277 for an interpretation of this section); I.R.C. § 121(A)(2) (*and see* special rule (d)(3) under this subsection); I.R.C. § *216; I.R.C. § 1034(F). But see* I.R.C. § 165(c)(3). *See generally, Tax Problems of the Cooperative Housing Corporation and their Tenant-Stockholders*, CCH 1961 STAND. FED. TAX. REP. ¶ 3928 (June 1, 1961).

while in the same state the court in *In re Miller's Estate*[13] reasoned that, considered separately, the stock and lease would be personalty, and the fact that both were required to evidence ownership would not seem to affect their legal classification.[14]

The possible applicability of the Uniform Commercial Code[15] to cooperative apartment stock had never been considered until the recent decision in *Silverman v. Alcoa Plaza Associates*,[16] dealing with the sale of cooperative stock. In *Silverman* the plaintiff buyer brought an action to recover a deposit declared forfeited by defendant seller because of buyer's breach of a contract to purchase cooperative stock and a proprietary lease. The court was faced with the task of determining whether the contract dealt with realty or personalty, as the measure of damages would differ accordingly. Having to operate without the aid of direct precedent, the lower court treated the stock as realty,[17] only to be reversed at the appellate level where the higher court decided that cooperative stock was personalty subject to the Uniform Commercial Code. The court rejected a realty application.[18] Its primary consideration was whether the sale was one of goods and subject to Article 2 of the UCC,[19] or one of securities subject to Article 8.[20] Specifically, the court held that the stock was "goods" as defined in the UCC and that damages could be recovered only as provided for in UCC § 2-718.[21] Two justices dissented, arguing that

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[13]205 Misc. 770, 130 N.Y.S.2d 295 (Sur. Ct. 1954).

[14]For another case relating the stock to personalty see Susskind v. 1136 Tenants Corp., 43 Misc. 2d 588, 251 N.Y.S.2d 321 (Civ. Ct. 1964) (stock and leasehold together considered personalty in suit to require corporation to repair underflooring). Other cases considering the stock as personalty in the construction of a will are *In re* Turner's Estate, 36 Misc. 2d 684, 233 N.Y.S.2d 108 (Sur. Ct. 1962); and *In re* Estate of Schlesinger, 22 Misc. 2d 810, 194 N.Y.S.2d 710 (Sur. Ct. 1959).

[15]The Uniform Commercial Code (hereinafter referred to as UCC) has been adopted in the District of Columbia, Virgin Islands, and all states except Louisiana.

[16]37 App. Div. 2d 166, 323 N.Y.S.2d 39 (1971).

[17]8 UCC REP. SERV. 57 (1970), reports the decision of the lower court.

[18]323 N.Y.S.2d at 44-45. The court pointed out that none of the classic clauses that are found within the standard real estate contract were present and that the contract in fact called for payment of the required stock transfer stamps.

[19]UNIFORM COMMERCIAL CODE § 2-105(1). In this section "goods" are defined as "all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities (Article 8) and things in action."

[20]Article 8 deals with bearer bonds formerly covered by the Uniform Negotiable Instruments Law and with registered bonds. It also covers certificates of stock, formally provided for by the Uniform Stock Transfer Act and additional types of investment paper not previously covered by any uniform act.

[21]Section 2-718 provides for liquidation or limitation of damages, and where, as here, there is no liquidation clause, the seller is limited to twenty percent of the value of the total performance for which the buyer is obligated under the contract or $500, whichever is smaller.

the UCC should not apply and that the cooperative stock should be regarded as realty, since ownership thereof involved possession of so many of the rights and obligations peculiar to fee ownership.[22]

If other courts agree with the reasoning of the majority in *Silverman* that the UCC should apply, some much-needed uniformity would be provided for the purchase or sale of cooperative stock and a proprietary lease. The UCC itself is authority for a liberal construction of its provisions to further its policies.[23] The drafters' comments indicate that the code is drawn flexibly enough to deal with novel and unusual types of commercial transactions,[24] and for illustration cite with approval the New York case of *Agar v. Orda.*[25] *Agar,* decided in 1934 after the old Uniform Sales Act[26] was passed, applied that Act to a contract for sale of choses in action even though the coverage of the Uniform Sales Act was intentionally limited to "goods" other than choses in action. In drawing its conclusions the *Agar* court reasoned that while corporate shares are intangible property, and for many purposes must be considered "things in action,"[27] for practical purposes they are merged into stock certificates which are treated by businessmen as property. Since they are treated in the market place as "goods", the decision was that they were "goods" and subject to the limited remedies provided for in The Uniform Sales Act.[28]

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[22]323 N.Y.S.2d at 46-47.

[23]UNIFORM COMMERCIAL CODE § 1-102.

[24]*Id.*, Comment 1.

[25]264 N.Y. 248, 190 N.E. 479 (1934). *Agar* and *Silverman* dealt with the same basic issue, a contract for the sale of corporate stock, except that in *Agar* it was the sale of 6 percent cumulative preferred stock in a corporation rather than cooperative apartment stock.

[26]190 N.E. at 479-80. The Uniform Sales Act was promulgated in 1906 and was adopted by 34 states and Alaska, the District of Columbia and Hawaii. Article 2 of the UCC is a complete revision of the Uniform Sales Act. *Uniform Commercial Code* § 2-101, Comment.

[27]190 N.E. at 481 includes in the definition of "goods" under the Uniform Sales Act all chattels personal other than things in action.

[28]In the Uniform Sales Act there could be an action for the price where title had passed to the buyer. However, in an executory contract, even if the goods were tendered, the common law rule was changed, and there could only be a claim for damages.

In contrast UNIFORM COMMERCIAL CODE §§ 2-709 (Sales) and 8-107 (Investment Securities) provide for an action for price. The remedy in Section 2 is generally limited to those cases where resale of the goods is impracticable or they have been destroyed after risk of loss has passed to the buyer. If the seller retains the goods the action can only be sustained after a reasonable effort to sell at a reasonable price. The comment to Section 8-107(2) states that it is designed to follow the dictum in *Agar v. Orda.* The seller can maintain an action under this section only for securities accepted and for rejected securities if efforts at their resale would be unduly burdensome or there is no readily available market, as in the *Agar* case.

By analogy to the liberal approach employed in *Agar*, approved by the drafters of the UCC, it is apparent that the *Silverman* court is on firm ground, and, with all jurisdictions but one adopting the UCC, the machinery is at hand to provide uniformity in transactions for cooperative stock. It remains to be decided, however, whether the stock should be governed by Article 8, which deals with investment securities, as well as Article 2.[29] In addition to the UCC's own suggestion that its provisions not be narrowly construed, there is authority in case law for including within Article 8 stock not specifically described by that Article.

A security is defined in § 8-102(1)(a) of the UCC as an instrument which:

> (i) is issued in bearer or registered form; and
> (ii) is of a type commonly dealt in upon securities exchanges . . . or commonly recognized . . . as a medium for investment; and
> (iii) is either one of a class or series or . . . is divisible into a class or series of instruments; and
> (iv) evidences a share, participation or other interest in property or in an enterprise or evidences an obligation of the issuer.

This definition has been liberally construed. In a New York case[30] involving an oral contract for the sale of stock, the plaintiff argued that as the stock contained limitations on its transfer and therefore was not a type commonly involved in securities exchanges, the Statute of Frauds[31] in Article 8 would not apply. The court dismissed the petition, holding that the UCC's definition of a security was intended to include all shares of stock, not only those dealt with by security brokers and their customers. A similar result occurred in a Virgin Islands case[32] where the U.S. District Court held that a subscription to unissued stock of a corporation was a security under Article 8 and a sale within the meaning of the Statute of Frauds.

It might also be noted that the only reference to cooperative apartment stock in the UCC is in the comment to § 8-204,[33] and by inference it

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[29]323 N.Y.S.2d at 43. The court recognized the close relation to Article 8 and pointed out its belief that if Article 8 were to apply the result would have been the same, for "even if Article 8 (Investment Securities) is deemed to apply to cooperative apartment stock where Article 8 is silent, Article 2 is applicable."

[30]Previti v. Rubenstein, 3 UCC REP. SERV. 882 (N.Y. Sup. Ct. 1966), *aff'd mem.*, 282 N.Y.S.2d 157 (App. Div. 1967).

[31]UNIFORM COMMERCIAL CODE § 8-319 contains a statute of frauds expressly designed to apply to investment securities.

[32]Cooper v. Vitraco, Inc., 8 UCC REP. SERV. 553 (D.V.I. 1970).

[33]UNIFORM COMMERCIAL CODE § 8-204, Comment 3, provides:

> Cooperative associations and ventures, as well as private clubs are gener-

appears that there was no intention to prevent the stock from being included in Article 8.

There are two problems which must be overcome if cooperative apartment stock is to be included within Article 8. First, the comment to § 8-102 indicates that the securities included in Article 8 are those regulated by the Securities Act of 1933 or a state Blue Sky Law.[34] The Securities Act expressly exempts a cooperative housing corporatin from regulation,[35] as does the Securities Exchange Act of 1934[36] when the stock is sold by a licensed real estate broker. In a parallel situation the shares are usually exempt from state Blue Sky Laws where there is a lack of profit motive; however, in some jurisdictions "profit" has been expanded so as to make unsafe any dependence on its usual meaning in determining which shares are exempt.[37] The same comment of the UCC which creates this problem also provides a logical solution in the statement that the definition is not limited to these regulated securities. Moreover, it points out that the definition is functional rather than formal.[38] It would be a reasonable deduction, therefore, that this part of the definition would not bar the admission of cooperative stock to the coverage of Article 8.

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ally considered an exception to the rules against restrictions on transfer as unreasonable restraints on alienation and are permitted for example to require the consents of governing bodies such as a board of directors.

Penthouse Properties, Inc. v. 1158 Fifth Ave., Inc., 256 App. Div. 685, 11 N.Y.S.2d 417 (1939).

[34]UNIFORM COMMERCIAL CODE § 8-102, Comment.

[35]*See* 17 C.F.R. § 230.235 (1971); 4A POWELL ON REAL PROPERTY ¶ 633.17(4) (1971).

[36]17 C.F.R. § 240.15a-2 (1971). In addition, if they qualify, sales by others than real estate agents are permitted. Securities Exchange Act of 1934, 15 U.S.C. § 78*l*(g)(2)(F) (1970).

[37]Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961) held that investment in a country club, not yet constructed, involved an element of risk and a "return" was expected in one form or another, so the shares were a security under the state law. In the case of Pine Grove Manor Section No. 1, Inc. v. Director Div., Dept. of the Treasury, 68 N.J. Super. 135, 171 A.2d 676 (1961), a "non-stock" cooperative apartment corporation was involved. The court held that plaintiff was not exempted from a corporation business tax as a non-profit corporation because there would be "profitable advantages that inure to their benefit." On this precise issue a Pennsylvania court reached the same conclusion in Commonwealth v. 2101 Cooperative, Inc., 27 Pa. D. & C.2d 405, *aff'd per curiam*, 408 Pa. 24, 183 A.2d 325 (1962).

State *ex rel.* Troy v. Lumbermen's Clinic, 186 Wash. 384, 58 P.2d 812 (1936), involved a cooperative plan for a group sharing of medical expenses and it was held that the Blue Sky Law applied. The court said profit was not necessarily a direct return by way of dividends; a savings of expense was also a profit to the person benefited. *Lumbermen's Clinic* was cited with approval in a similar holding in State *ex rel.* Russell v. Sweeney, 153 Ohio St. 66, 91 N.E.2d 13, 16 (1950).

[38]Note 34 *supra.*

The second problem is in the body of the definition of a security wherein the stock is required to be "of a type commonly dealt in upon securities exchanges . . . or commonly recognized . . . as a medium of investment . . . ." Since the cooperative corporation stock is accompanied by a proprietary lease, it could be argued that it is not a type commonly dealt in upon exchanges and therefore would have to qualify as a medium of investment. An investment has been defined in case law generally as the placing of capital or laying out of money with the intention to secure income or profit from its employment.[39] As the UCC itself begs to be construed liberally[40] and the meaning of "profit" has been expanded to include "profitable advantages that inure to one's benefit" or a "savings of expense,"[41] it follows that there is a rational basis for inclusion of cooperative apartment stock within the class of securities covered by Article 8.

With the advantageous exemption of cooperative stock from federal control in the Securities Act of 1933 and the Securities Exchange Act of 1934 (except where it does not qualify), and its exemption from many state Blue Sky Laws,[42] cooperative stock remains unregulated in a large part of the country. If it is denied coverage under the UCC, it will not be covered under any uniform laws. Therefore, to foster uniformity the stock should be included within the purview of Article 8, for unlike Article 2, Article 8 deals generally with the issue, purchase and registration of securities. As the comments of the UCC point out, Article 8 was intended to be read with Article 2, and where Article 8 is silent Article 2 is to supply the needed guidance.[43]

Treating cooperative stock as realty or various forms of personalty does not provide uniformity, while if the shares were brought within the regulation of Article 8, there would be advantages to both buyer and seller.[44] For instance, if the stock is considered realty, there should be a

[39]SEC v. Timetrust, Inc., 28 F. Supp. 34 (N.D. Cal. 1939); SEC v. Wickham, 12 F. Supp. 245 (D. Minn. 1935); State v. Hofacre, 206 Minn. 167, 288 N.W. 13 (1939); State v. Gopher Tire & Rubber Co., 146 Minn. 52, 177 N.W. 937 (1920); *In re* Bowen, 141 Ohio St. 602, 49 N.E.2d 753 (1943); Brownie Oil Co. v. Railroad Comm'n, 206 Wis. 88, 240 N.W. 827 (1932).

[40]Note 23 *supra.*

[41]Note 37 *supra.*

[42]By its analogy to realty and where the meaning of "profit" has not been liberalized, cooperative stock has in some jurisdictions been exempted from state Blue Sky Laws.

[43]UNIFORM COMMERCIAL CODE § 2-105, Comment. This comment points out that while investment securities are expressly excluded from the coverage of Article 2, the application of a particular section of Article 2 by analogy to securities (as was done in *Agar v. Orda*) is permissible when the reason of that section makes such application sensible, and the situation involved is not specifically covered by Article 8.

[44]For a detailed consideration of other problems facing an attorney asked to represent a prospective buyer of cooperative stock, see Jervis, *Problems in the Purchase of a Cooperative Apartment,* 5 PRAC. LAW., Nov., 1959, at 83.

title search and a recording of interest when a purchase is made; if an investment security, Article 8 requires a registration of a transfer[45] which would provide notice of adverse claims and give some certainty of ownership.[46] Another advantage[47] would be § 8-319, the article's own Statute of Frauds,[48] which permits a more liberal signature requirement with none being required if a writing is not rejected within ten days after confirmation has been received. Minimum specifications for quality and price may be established by business usage. Article 8 also has very precise attachment and levy rules requiring an officer to actually and physically seize the share before attachment is valid.[49] Also, this article provides for the issuance of new certificates if the originals are lost or destroyed.[50] Since there appears to be no reason why an inclusion in Article 8 should adversely affect the favorable treatment the corporation and its tenant-stockholders enjoy under the Securities and Internal Revenue Acts, it is apparent that Article 8 would provide the most comprehensive or satisfactory regulation of transactions in this field of commerce. In the spirit of uniformity called for in *Agar*[51] and the realization that the interest has not been given a name, as indicated in *Lacaille v. Feldman*,[52] cooperative stock and a proprietary lease should be denominated an investment security within the UCC, and it only remains for the courts to do so.

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[45]UNIFORM COMMERCIAL CODE § 8-401 sets forth the duty of an issuer of stock to register a transfer of stock when so requested.

[46]*Id.* § 2-107(3). This section provides for recording, if desired, of the contract for sale as transferring an interest in land which is notice to third parties of the buyer's rights.

[47]Another potential advantage might appear in jurisdictions which still recognize a spouse's dower right. If the stock is realty, the question arises if there should be a release of dower when there is a transfer, while if it is considered a security under Article 8 this problem should not arise.

[48]UNIFORM COMMERCIAL CODE § 8-319. This section contains the Statute of Frauds as applied to the contracts for the sale of securities.

[49]*Id.* § 8-317. Not only is the attachment procedure set out, but also the method by which a creditor may reach such a security.

[50]*Id.* § 8-405. This section also provides for protection of the issuer if notice is not timely.

[51]Note 25 *supra.*

[52]44 Misc. 2d 370, 253 N.Y.S.2d 937 (Sup. Ct. 1964).