

CHAPTER 3. BASIC STRUCTURE AND ORGANIZATION OF COOPERATIVE CORPORATIONS INSURED UNDER THE NATIONAL HOUSING ACT

3-1. INTRODUCTION. All cooperative corporations, prior to solicitation for memberships, must obtain HUD approval of the following organizational documents: Articles of Incorporation; By-Laws; Regulatory Agreement; Information Bulletin; Subscription Agreement; Occupancy Agreement and Cooperative Agency Agreement, if any. In the case of Existing Construction projects and cooperatives purchasing Investor-Sponsored projects, a Sales Agreement is also required. In addition, the approval of the Attorney General or other governmental official of such documents may be required in some States.

3-2. MODEL FORMS OF ORGANIZATIONAL DOCUMENTS IN GENERAL.

- a. Model forms of the required organizational documents have been issued. If followed, with such modifications or changes as may be necessitated by local statutes or by conditions peculiar to a specific project, they will meet HUD-FHA requirements and should provide the basis for a sound organization. The legal adequacy of the organizational documents will be determined by the Area HUD Counsel and the Director is responsible for their approval from the administrative standpoint.
- b. In order to expedite the examination of the organizational papers, the parties should be required to submit not only typed copies thereof but also marked-up drafts on the model forms, with changes therein shown by deletions and interlineations.
- c. Any change in the model forms which would have an adverse effect on policies set forth in the Regulations or this Handbook requires the prior approval of the Office of Underwriting Standards. This approval will be given only after submission of the proposed documents with the HUD-FHA Director's recommendations. A brief statement of the reason for each change and citation of state law, if relevant, should accompany these drafts.

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- d. The model forms and documents described in this Chapter of the Handbook are basic in the organization of a management type cooperative. Each section covering a different approach in organizing a cooperative, i.e., Investor-Sponsor, Sales Type, etc., has a model form or document containing the appropriate language or conditions for that approach.

3-3. MODEL FORMS OF INFORMATION BULLETINS, SECTION 213 AND SECTION 221 (d)(3) MARKET INTEREST RATE.

- a. FHA Form No. 3241. This form is used in Insurance of Advances, and Insurance upon Completion cases by all unsubsidized management type cooperative corporations except those purchasing an "Existing Construction project under Section 213(i)" or an "Investor-Sponsored" project.
 - b. FHA Form No. 3241-A. This form is used by Management Type cooperatives purchasing an "Investor-Sponsored" project or an "Existing Construction" project.
- 3-4. GENERAL INSTRUCTIONS APPLICABLE TO ALL INFORMATION BULLETINS. An Information Bulletin is not a formal legal document but it must accurately describe the proposed cooperative and the method in which it is being organized. It must contain general information concerning the cooperative housing concept and direct the attention of the subscribers to the formal documents that legally constitute the corporation. Some of the other items of information that will be covered by it are as follows:
- a. U. S. Income Tax Deductions. The model forms indicate that under normal circumstances, the cooperative members may deduct from their gross income for tax purposes their proportionate share of real estate taxes and mortgage interest paid by the cooperative. The Information Bulletin should not, however, contain any estimate or tabulation of the tax savings, since this will vary according to the income and deductions of the individual taxpayer.
 - b. Cooperative Housing as New Residence for Income Tax Purposes. A member of a cooperative has available to him the same basic federal income tax advantages available to a home owner who sells his home and purchases a new one.

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- (3-4) Residence has been defined by the Internal Revenue Service to include a cooperative apartment. If a person sells or exchanges his principal residence at a gain, the gain is taxable. However, if within the year before or the year after the sale, the seller buys and occupies another residence, the gain is not taxed at the time of the sale if the cost of the new residence equals or exceeds the adjusted sales price of the old residence. More complete information about this can be obtained from Reference (7) of the Foreword. Cooperative members are also entitled to state income tax deductions in some jurisdictions.
 - c. U. S. Securities and Exchange Commission Requirements. Securities may be exempt from SEC registration requirements, pursuant to Section 3(a)(11) of the Securities Act, if the issuing corporation (1) was organized under the laws of a particular state; (2)

transacts business solely within such state; (3) makes the security offering exclusively to residents of such state; and (4) effects sales of the securities only to bona fide residents of such state who do not intend to resell the securities to non-residents. If examination of the mortgagor's papers reveals that the stock issuance has not been handled within these limitations, written evidence of SEC clearance is required. The SEC has indicated in some cases that a cooperative corporation set up on a membership, as distinguished from a stock, basis may be excused from SEC registration. Rule 235--General Rules and Regulations under Securities Act of 1933 exempts cooperatives from registration under circumstances stated therein.

- d. State Securities Requirements. The organizers of cooperative housing corporations should ascertain what state requirements, if any, pertaining to the issuance of securities must be complied with prior to solicitation for memberships. For example, the states of California and New York have specialized requirements on this subject.
- e. Estimate of Monthly Carrying Charges. The Information Bulletin contains a schedule showing the estimated monthly carrying charges which will be payable by the members. It is on the basis of this schedule that members are solicited. Their decision may be influenced by the fact that a management agent and HUD have approved the

(3-4) adequacy of the amounts shown. It is, therefore, essential that the expenses on which this schedule is based not be underestimated.

- f. Review and Coordination of the Information Bulletin to the Budget. The Director should designate a member or members of his staff who are experienced in property management, preferably cooperative property management, to review these estimates against the HUD Data Bank at the time that the Information Bulletin with its attendant schedule of carrying charges is submitted for HUD approval. It is required that the budget and estimate of carrying charges be set forth on the Model Form of Operating Budget HUD Form 93240, as discussed in the pages to follow. The Reviewer should recognize that the sponsorship may have a tendency to underestimate expenses so as to facilitate sale of memberships in the project, and he should, therefore, closely examine the estimates submitted by the sponsorship and management agent and increase them if he feels them to be inadequate. Such increased estimates should, of course, be the ones to be reflected in the Information Bulletin.
- g. HUD Approval of Changes in the Format of Information

Bulletins. The model forms described above may be adapted for use by a cooperative servicing agent or its counsel with such changes as may be deemed necessary under the circumstances and with the approval of the HUD-FHA office. It will be the responsibility of the Area Counsel to determine when departures are of such substance that they should be cleared with the Office of Underwriting Standards. *

h. Personal Benefit Expense (PBE).

- (1) The cooperative budget and schedule of carrying charges does not reflect PBE expenses. They are the direct responsibility of the individual members.
- (2) The PBE items (set forth in the application and in the Occupancy Agreement) gives the members an opportunity to exercise individual control over some expenses that relate to them personally.

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- (3-4) (3) PBE usually includes decoration of the interior of the member's unit and may include other items, such as utilities, which are paid for directly by the cooperative member.
- (4) The cooperative home ownership concept may lend itself to more extensive self-help than the painting and decoration of unit interiors. If it is used more extensively, e.g., in areas of grounds maintenance, painting of common areas, etc., it must be done in accordance with a plan that is approved by HUD.

- i. Proportionate Factor of Unit Valuation to Total Valuation. In Item 9, Column 2 of the Information Bulletin a valuation is set forth for each unit in the project. A decimal factor should be developed by dividing the valuation assigned each individual unit by the total valuation of all units in the project, e.g., a unit with a \$10,000 valuation in a \$1,000,000 total valuation develops a proportionate factor of .0100 (1%). Increases and decreases in carrying charges should be apportioned by the use of this factor. The factor may also be used to determine the proportionate share for each unit of the total amounts paid by the cooperative for mortgage interest, real estate taxes and other line items on the budget. Interest and real estate tax information is useful to the members in connection with their filing of federal income tax returns. The interest and real estate taxes attributable to a unit may need to be broken down further in projects receiving HUD federal assistance to determine how much an assisted member has actually paid. Management agents should check further IRS rulings in connection with assistance payments as there has been no specific ruling as of the

date of this Handbook.

- j. Articles/Certificate of Incorporation. There is no requirement that the cooperative be incorporated under any particular state statute.
 - (1) In many states there is no appropriate legislation on the subject of cooperatives; while in others, legislation dealing with cooperative corporations relates to agricultural and marketing cooperatives, and is not applicable to housing cooperatives. Even where state statutes dealing with cooperative corporations permit housing cooperatives, the circumstances of the case may make incorporation thereunder undesirable.

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- (3-4) (2) In the absence of applicable legislation, if the general incorporation statutes permit incorporation of the cooperative pursuant to the FHA model form, such incorporation is unobjectionable. But if appropriate "cooperative" or "non-profit" incorporation legislation has been enacted, incorporation should normally be affected under such legislation.
 - (3) Determination of the statutory requirements in a given state, and determination of the specific changes in the model form of Certificate of Incorporation needed as a result of such statutes, is a responsibility of the Regional Counsel. Changes in the certificate of incorporation required to meet statutory requirements may be approved by the Director on the recommendation of the Area Counsel. Determination of the statutory requirements in a given state and of the specific changes in the model form of Articles of Incorporation needed as a result of such statutes, as well as the acceptability of other changes proposed by the sponsor or counsel for the cooperative, is a responsibility of the Area Counsel. Such changes may be approved by the Director on the recommendation of the Area Counsel.
 - (4) The introductory wording in all certificates of incorporation will, of course, vary from state to state to comply with local procedures.
 - (5) It is preferred that the Commissioner's controls be based on a contract (Regulatory Agreement) rather than on the ownership of preferred stock. Therefore, the skeletal forms of Certificate of Incorporation should be used unless some valid reason exists for the controls to be evidenced via the ownership of preferred stock, in which case the

longer forms of Certificate of Incorporation should be used, as described below.

- (6) The par value of the common stock or membership may equal the total amount necessary to complete the project over and above the mortgage proceeds, plus the working capital deposit requirement if any. It is possible, however, for the necessary cash to be obtained partly from the sale of stock and partly from

other paid-in or donated capital, provided that at time of closing it is shown that the cash is unencumbered corporate property. It is required that each cooperative member be issued a membership certificate or one or more shares of stock.

3-5. MODEL FORMS OF CERTIFICATES OF INCORPORATION.

- a. FHA Form No. 3234-B. This form is used by cooperatives in Sections 213 and 221 where a Regulatory Agreement is used for control.
- b. FHA Form No. 3235. This form is used in management type projects and, as revised, covers both stock and membership corporations. It applies to Section 221(d)(3) as well as to section 213. This is the form which is used when there is no Regulatory Agreement.

3-6. MODEL FORM OF REGULATORY AGREEMENT, FHA FORM NO. 3225. This agreement is used by Management Type cooperatives under both Sections 213 and 221 when the Certificate of Incorporation, Form 3235, is used. In situations where one cooperative mortgagor owns two or more projects, each covered by an HUD-insured mortgage, the Regulatory Agreement shall be deemed a default under all other Regulatory Agreements executed by the cooperative.

3-7. MODEL FORM OF BY-LAWS, FHA FORM NO. 3245. This form is used in Management Type Mortgagor Corporations under Sections 213 and 221. The By-Laws set forth the rights, duties and responsibilities of the individual members, the officers and the directors; and will permanently govern the internal organization and operation of the cooperative group. The date of the annual meeting of member-subscribers must be incorporated in it.

3-8. MODEL FORM OF SUBSCRIPTION AGREEMENT, MANAGEMENT TYPE, FHA FORM NO. 3232. This form is appropriate for use in Section 213 and Section 221. A supplement to this form, FHA Form No. 3232-A relating to credit is required for each subscriber in these sections.

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- 3-9. MODEL FORM OF ADDITIONAL DOWN PAYMENT AGREEMENT, FHA FORM NO. 3232-B. This form is used by initial subscribers in Section 213 or Section 221 projects who desire to reduce the debt service charge to be included in their monthly payment by voluntarily making larger down payments than those required.
- 3-10. MODEL FORMS OF OCCUPANCY AGREEMENTS.
- a. FHA Form No. 3237. This form, as revised, is appropriate for use in Sections 213 and 221 cooperatives composed of one mortgage parcel. An Occupancy Agreement, fully executed, is required from each member in all management type projects. (For Interim Lease see Reference (8) of the Foreword.)
- b. FHA Form No. 3237-B. This document is similar to FHA Form No. 3237 except that it is used where the cooperative is to be composed of more than one mortgage parcel.
- 3-11. COOPERATIVE AGENCY AGREEMENT. In cases where the cooperative corporation is represented by a cooperative sponsoring organization, an agency agreement is used to spell out the relationship between the cooperative and such organization. No model form has been issued on this subject due to the variations in services, charges, and methods of payment involved. The form used is subject to clearance by the Director of the Field Office and no Washington submission is required in this connection, except that in cases where HUD is being requested to certify the cooperative to GNMA as a "consumer cooperative" the proposed agreement must be submitted to the Office of Underwriting Standards. *
- 3-12. "CONSUMER COOPERATIVE" CERTIFICATIONS TO GOVERNMENT NATIONAL MORTGAGE ASSOCIATION. Section 305(e) of Title III of the National Housing Act provides for the certification by the Secretary of HUD, under appropriate circumstances, to GNMA that a particular cooperative under Section 213 is a "consumer cooperative." A consumer certification procedure is not, however, required if the project is located in an urban renewal area, inasmuch as the GNMA allocation is made from another GNMA fund, nor for similar reasons is such a procedure required where the project is to be insured under Section 221.

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- a. Where the Director, after reviewing the facts in each case, has determined that a particular cooperative is entitled to a consumer certification, he shall forward his recommendation on the subject to the Office of Underwriting Standards. *

- b. If such certification is ever required the HUD-FHA Director should forward the certification in accordance with the section of this Handbook titled Sponsorships and Sponsorship Organizations, together with his recommendations. (See Chapter 1.)
 - c. In those cases where the cooperative is represented by a sponsoring agent having no interest in the builder or landowner, additional certification shall be obtained from the sponsoring group to the effect that there is no identity of interest between the sponsoring individual(s), or the officers, directors, and stockholders of the sponsoring organization, and the builder or landowner. In such cases the person or organization representing the cooperative must also submit a copy of its proposed cooperative agency agreement, as well as a statement setting forth its experience and qualifications in acting on behalf of cooperative corporations. The circumstances of a particular case may require further information or certification, as it is important that the Director satisfy himself that no identity of interest exists.
- 3-13. HUD FUNCTIONS DURING SOLICITATION PERIOD. HUD's functions during this period are primarily those of review and approval or disapproval of proposed members from a credit standpoint. In Management and Sales Type cases, until sufficient membership has been attained and approved by HUD and the required sum of money over and above the mortgage has been raised, there will be no endorsement. Rapid processing of subscription agreements is essential to successful development of the cooperative and it is expected that they will be processed as received in convenient groups rather than withholding processing until all units have been sold.
- 3-14. INITIAL OPERATING BUDGET AND INITIAL SCHEDULE OF CARRYING CHARGES, HUD FORM NO. 93240, (APPLICABLE TO ALL COOPERATIVES). This form should be prepared at the same time as the Information Bulletin and must reflect current estimates.

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- (3-14) a. One of the Prime Responsibilities imposed by the By-Laws on the initial and subsequent Boards of Directors of a cooperative is to adopt an annual operating budget and HUD-93240 is to be used for this purpose. The form is coded to the Uniform System Chart of Accounts and can be expanded to serve the more complex cooperatives.
 - b. The Annual Cost of Operating a Cooperative varies with the characteristics of the development, whether it is new construction or rehabilitation, and the services required by its owners.
 - c. Budgets should be prepared by listing the annual

expenses that result from a study of the characteristics and experience of the development and not by working backward from what is considered to be the current market rentals of the area.

- (1) A Schedule of Carrying Charges and a management agent's opinion as to its adequacy must be included in the Information Bulletin. Therefore the Initial Schedule of Carrying Charges must be prepared considerably prior to actual operations. Column 5 (New Annual Budget) should show expense items reflecting the best judgment of the sponsorship and management agent. The HUD-FHA office will reflect any revisions it considers appropriate in the last column, and the schedule reflected in the Information Bulletin must give effect to these revisions. The expense projections contained in the Project Analysis (Form No. 2264-C) are made for a different purpose and should not necessarily be regarded as adequate for the cooperative budget. Upon final approval of a budget it should be forwarded to the appropriate underwriting section for inclusion in the Data Bank.
- (2) Estimates of Income, particularly in budgets prior to the attainment of operating experience, must be conservative. In the initial budget, the estimated income from garage space must not exceed fifty (50) percent of the total for this item shown in the Project Analysis (FHA Form No. 2264). Such budget should not reflect any estimated income from such miscellaneous

sources as laundry machines, telephone services, vending machines, etc. Income from commercial space may be reflected only to the extent of leases actually executed with the HUD-FHA office approval.

- (3) Fixed Charges are requirements affecting the budget entries on lines 49 through 54 (Ground Rent, Mortgage Insurance Premium, Interest, Principal, Replacement Reserve and General Operating Reserve) are set forth in the Regulatory Agreement and/or the Commitment for Insurance. The total income on line 68 must be at least equal to the total expense on line 58. The income from carrying charges on line 59 must agree with the annual total in the schedule of carrying charges.
- (4) The expenses should be compiled as realistically as possible. Tax authorities, insurance companies, utility companies, suppliers and manufacturers of project equipment are good sources of information. Local building owners and managers associations are also good sources of information. The catalog of a

large retail store is useful in estimating the cost of supplies and equipment. Other cooperatives with comparable facilities and services, that have been operating for more than one year, can also be a valuable source of information.

- (5) In all Section 213 and 221(d)(3) Market Interest Rate cases in which down payments of less than \$500 are involved, the initial operating budget must contain an allocation for vacancy and collection losses of at least 2 percent of the budget otherwise projected. If the experience of nearby or comparable projects indicates this to be inadequate, a higher percentage should be required. Budgets prepared after the cooperative is in actual operation should contain such allocation as is justified by its own operating experience.

- 3-15. OPERATING BUDGET AND SCHEDULE OF CARRYING CHARGES DEVELOPED AFTER OCCUPANCY. Column 1 will show the prior year's budget and Column 2 the actual figures for the previous twelve months'

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operation. Column 4 will be used to adjust for increases or decreases that may be necessary and Column 5 will show the proposed operating budget for the coming fiscal year. The HUD-FHA Office will use the last Column to show any revision in estimates.

- 3-16. GENERAL INFORMATION FOR PREPARATION AND SUBMISSION. Additional information can be found on HUD Form No. 93240.
 - a. Replacement of Withdrawals From the General Operating Reserve. Provision must be made for replacing withdrawals with deposits during the next fiscal year (or in accordance with a previously approved repayment plan). Such deposits, over and above the amounts required to meet the regular annual requirement must, therefore, be included on line 54 of the Operating Budget.
 - b. Painting Reserve. Experience has demonstrated the value of establishing such a funded reserve as a means of avoiding special assessments.
- 3-17. BUDGETING FOR A SINGLE COOPERATIVE CORPORATION HAVING SEVERAL MORTGAGE PANELS. A cooperative that has been developed in sections, wherein each section imposes a separate mortgage obligation on the single corporation, may operate on a consolidated budget reflecting the total operation. The books of account, however, must be kept in a manner that will permit financial identification of each mortgage panel.

- 3-18. BUDGET APPROVAL. The form is required to be signed by the managing agent, a Director of the cooperative and the HUD-FHA Office. A copy as finally approved should be available for examination by the cooperative members.
- 3-19. PLAN OF OPERATION. Each annual budget must indicate the management plan that is intended to be used to implement it. The plan should cover such items as the following:
- a. Schedule of personnel to be directly employed by the cooperative - including their compensation and duties.
 - b. How often will a property manager from the management company visit the project?

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- c. Will the managing agent attend all Board Meetings?
 - d. What member committees are organized to assist in management (Budget, Grounds, Collections, Finance)?
 - e. Will the management agent or resident manager contact delinquents in person?
 - f. Is a delinquent member called before the Board prior to turning his account over to an attorney or collection agency?
 - g. Have the maintenance personnel been given a maintenance and operations guideline to keep the cooperative's operating costs at the lowest possible level?
 - h. Have the on-premises personnel been given copies of plans, specifications, and corporate documents, and have they been made aware of the requirements imposed by the Regulatory Agreement on the management firm?
 - i. If any expense items (grounds maintenance or painting and decorating) have been reduced by use of self-held techniques, the detailed plan should be submitted.
- 3-20. ALLOCATION REAL ESTATE TAXES. The reviewer should compare the data from other projects on taxes and other operating expenses with the estimates which have been submitted. The estimates should not deviate significantly from the totals on Form 2264 without proper justification. The importance of providing subscribers with the soundest possible estimate of carrying charges cannot be over-emphasized.
- a. Real estate taxes are admittedly difficult to forecast. The HUD-FHA reviewer should examine the amount for real estate taxes estimated by the sponsor for reasonableness by comparing the sponsor's estimate with the amount of taxes being charged for similar properties in the area. It should be borne in mind that real estate taxes have been constantly increasing in many areas. Both the

sponsor and the HUD-FHA should take this factor into consideration.

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- b. If long-term real estate tax abatement or if exemption from taxes is claimed by the sponsor, approval of the HUD General Counsel must be obtained.
- 3-21. GENERAL OPERATING RESERVE. The Regulatory Agreement requires that the cooperative establish and maintain a general operating reserve by allocation and payment thereto monthly of a sum equivalent to not less than 3 percent of the monthly amount otherwise chargeable as carrying charges. When the GOR account reaches 15 percent of the annual carrying charges, the monthly accrual rate may be reduced to 2 percent; and when the GOR account equals 25 percent of annual carrying charges, such monthly accruals may be discontinued until the account is reduced below 25 percent.
- 3-22. ALLOCATION FOR REPLACEMENT RESERVE. The Reserve for Replacements is one of the items included in the budget upon which the carrying charges are predicated, and must at least equal the amount required by the Commitment. The kitchen ranges and refrigerators in most cooperative units are assets of the corporation. The replacement reserve must, therefore, be sufficient to cover such items if included under the project mortgage, and likewise carpets and air conditioning, if any. These items should not be treated as personal benefit items. If the cooperative feels an incentive is necessary so that residents will be encouraged to take optimum care of the equipment covered by the reserve, there is no objection to its restricting disbursements so that one unit cannot draw more than its pro rata share of the accumulated reserve.

The above requirement also applies in Section 213 cooperatives except where down payments of \$500 or more are involved and it is customary for individuals to own their equipment as personal property. In such cases, a replacement reserve is required for items of corporate responsibility and not the items of personal property. Equipment such as kitchen ranges and refrigerators and carpets and drapes may properly be handled as personal benefit items in such situations. The By-laws and Occupancy Agreement must clearly indicate whether the corporation or the individual is responsible.

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- 3-23. OPINION OF INDEPENDENT MANAGING AGENT. The Information Bulletin is required to contain the opinion of a professional independent management agent as to the adequacy of the schedule. The management agent must be acceptable to HUD. It is expected that the management agent's opinion on this subject will be arrived at objectively and will not be

influenced by any desire to make the project more attractive from the sales standpoint. If a management agent has underestimated carrying charges in earlier projects without reasonable explanation, the HUD-FHA Director must require the opinion of another agent in future projects.

- 3-24. REVISION OF SCHEDULE PRIOR TO OCCUPANCY. In some cases, as a result of the time lapse between preparation of the Initial Schedule of Carrying Charges and the date of initial occupancy, there are changes in operating expense estimates sufficient to justify a revision of the operating budget and schedule of carrying charges.
- 3-25. FIGURES. The following Figure "A" schematically shows the financial structure of a cooperative corporation. Figure "B" is a sample of the budget format of a cooperative corporation.