

REAL ESTATE AND TITLE INSURANCE TRENDS

The Importance of Being 'Earnest'

Does Defaulting Co-op Buyer Forfeit Deposit? Well, Maybe

BY JAY R. FIALKOFF

THE NEW YORK CITY cooperative apartment market continues to thrive. Eager buyers shell out millions of dollars each month to buy apartments in cooperative apartment buildings.

Virtually every prospective co-op shareholder — like anyone else looking to buy a residence — puts down a deposit, most commonly 10 percent of the total purchase price, upon executing a sales contract. What happens if the buyer inexcusably fails to close? I would wager that 90 percent of the people reading this article would say "The seller keeps the deposit, of course." The answer, however, is — "The seller keeps the deposit, maybe."

The widely accepted assumption in real estate transactions is that a buyer who fails inexcusably to close title forfeits that "earnest money" to the non-breaching seller, who may simply retain the entire deposit as liquidated damages without proving actual loss. See, e.g., *Dmochowski v. Rosati*, 96 A.D.2d 718, 465 N.Y.S.2d 367 (1st Dep't 1983) ("It has long been the law of New York that '[a] vendee who, without breach on the part of the vendor, refuses to perform a contract for the purchase of real estate, cannot recover from the vendor either the amount paid on the purchase price, or a deposit by him as earnest money ... where the vendor is ready, able and

willing to perform upon his part.'") (citations omitted).

However, New York law does not view the purchase of a cooperative apartment as solely a "real estate" transaction. Accordingly, there is no automatic deposit forfeiture in co-op apartment purchase transactions (see, e.g., *Silverman v. Alcoa Plaza Associates*, 37 A.D.2d 166, 172, 323 N.Y.S.2d 39, 45 (1st Dep't 1971)).

Thus, the seller of a two bedroom condominium can expect to keep the down payment on breach, but the seller of the identically sized cooperative apartment across the street cannot be so sure. Inconsistent legal determinations in substantially similar factual settings result, which can precipitate needless commercial uncertainty in a co-op market where individual unit prices regularly exceed \$1 million and \$100-\$500,000 down payments have become commonplace. This article will discuss that problem briefly and suggest a solution.

Corporations which own co-op apartment buildings are not going commercial concerns in the customary sense. Their main non-commercial purpose is to serve resident shareholders, predominantly through maintaining the property in a habitable condition. Each shareholder acquires co-op "stock" packaged in relation to a particular apartment in the property, and a "proprietary" lease to that same unit, which memorializes the occupancy rights of the shareholder. The price of each co-op stock block necessarily reflects the perceived value

of the particular apartment to which the subject shares relate.

The recurring question, which neither legislators nor the courts have answered in a satisfactory fashion, is whether cooperative stock acquisition transactions involve real property, personal property, or a hybrid. New York courts traditionally have viewed real estate as unique (*Dimicu v. Groff Studios Corp.*, 257 A.D.2d 218, 690 N.Y.S.2d 220 (1st Dep't 1999)) and goods as fungible. They see the rights and interests bundled together in a cooperative share, however, as both things, or neither, and sui generis in essential legal character.

For example, in *In re Estate of Carmer*, 71 N.Y.2d 781, 784, 530 N.Y.S.2d 88, 89 (1988), the Court of Appeals had this to say: "The interest in a cooperative apartment is sui generis in modern property law, because it does not fit neatly into traditional property classifications; the interest is represented by shares of stock, which are personal property, yet in reality what is owned is not an interest in an ongoing business enterprise, but instead a right to possess real property." (citations omitted). A share of cooperative stock does not constitute a "security" under either the Securities Act of 1933 or the Securities Exchange Act of 1934. *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 95 S.Ct. 2051 (1975); *Grenader v. Spitz*, 537 F.2d 612, 616-19 (2nd Cir.), cert. denied, 429 U.S. 1009, 97 S.Ct. 541 (1976).

The Court of Appeals has described

cooperative stock as personalty, but also as embodying at least a beneficial real property interest in certain legal contexts. In the seminal case of *Matter of State Tax Commission v. Shor*, 43 N.Y.2d 151, 400 N.Y.S.2d 805 (1977), the Court was presented with the issue of whether a debtor's interest in a co-op apartment, namely, a stock certificate and a proprietary lease, qualified as real property, thereby enabling the judgment creditor to obtain a lien on the property simply by docketing her judgment.

The Court affirmed the lower court's decision that the ownership interest in a co-op apartment is sui generis, such that the leasehold and the shareholding are inseparable and that the debtor's interest constituted personal property, so that the mere docketing of a lien does not enable a judgment creditor to obtain a lien. *Id.* The Court noted that "[t]he growth of co-operative ownership of apartment buildings, throughout the Nation, but especially in New York City, has created legal problems not resolved by uncritical resort either to the rubrics governing real property or those governing personal property." 43 N.Y.2d at 156, 400 N.Y.S.2d at 807.

At bottom, just what species of property co-op stock constitutes — real and/or personal — seems to depend upon the reason why that evaluation is undertaken and the particular factual setting in which its legal character is assessed. This chronic legal "identity crisis" or "paradox" makes the decisional law difficult to reconcile and ultimately can undermine commercial certainty in the real estate marketplace.

Looking at the Cases

Thirty years ago, before co-op conversions and co-op ownership became as popular as today, the First Department held that the ability to retain a deposit when a contract for the sale of a co-op was breached, was subject to a "liquidated damages" analysis under §2-718 of the Uniform Commercial Code. *Silverman v. Alcoa*

Plaza Ass., supra. That section provides that "damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty." That a deposit forfeiture is subject to such analysis clearly encourages litigation, which can necessitate costly motion practice or even a hearing.

There doesn't seem to have been much in the way of reported cases on the issue after *Silverman*. One lower court case decided in 1986, *Shulkin v. Dealy*, 132 Misc. 2d 371, 504 N.Y.S.2d 342 (Sup. Ct. N.Y. Co. 1986), applied UCC 2-718, and found the \$29,000 down payment to be a reasonable liquidated damages clause, rather than a penalty, since the amount was smaller than the actual damages suffered by plaintiff and upheld retention of the down payment. In *Chien v. Tova Realty*, 151 Misc. 2d 710, 573 N.Y.S.2d 855 (Civ. Ct., Queens Cty 1991), the court refused to allow the forfeiture of a 10 percent deposit on the ground that defendants had not offered sufficient proof that retention of the down payment was "reasonable."

In 1993, the First Department allowed a seller to retain a 10 percent down payment of \$63,500 on a \$630,000 contract of sale where the apartment was sold seven months after breach for only \$5,000 less. *Wojciechowski v. Birnbaum*, 191 A.D.2d 247, 595 N.Y.S.2d 3 (1st Dep't 1993). The court held that assuming arguendo the contract was governed by UCC Article 2, forfeiture of the down payment did not constitute a penalty, since the down payment amount was not unreasonably large.

More recently, three reported cases raised the issue, indicating the likelihood of continued litigation over down payments and the necessity of attempting to provide a clear legal rule

for the cooperative marketplace. In *Savasta v. Duffy*, *New York Law Journal*, March 20, 1998, p. 26 (Sup. Ct. NY Co.) (Miller, J.), plaintiff signed a contract of sale to purchase a cooperative apartment for \$1,050,000, and put down 10 percent as a contract deposit. A dispute arose, and no closing occurred. Buyer then sued for specific performance. Seller counterclaimed for retention of the deposit. The court held that the standards employed in real estate law would determine whether to grant specific performance of the purchase agreement, but that the UCC would determine whether the seller was permitted to retain the down payment.

After finding that plaintiff-buyer had impermissibly failed to close, the court still refused to allow the seller to keep the down payment on a motion for summary judgment. Defendant was granted leave to renew the motion upon submission of appropriate documentation (evidence of actual loss, attorneys' fees, moving expenses, rent) to establish whether retention of the full contract deposit was proportionate to the damages actually arising from the breach.

In *Fleck v. Daniel*, *NYLJ*, Sept. 5, 2000, p. 21 (Sup. Ct. N.Y. Co.) (Shainswit J.), buyer contracted to purchase a cooperative apartment for \$1,150,000, and put down a contract deposit of 10 percent of the purchase price. Thereafter, purporting to invoke a clause entitling buyer to terminate the contract, buyer terminated and demanded return of the down payment. Seller refused, and quickly resold the apartment to a nonparty at a higher price. In the action by buyer to recover the 10 percent down payment, the court applied 2-718 of the UCC and held, relying on real property cases that have upheld forfeiture of 10 percent down payments, that 10 percent was deemed reasonable at the time of execution of the contract of sale and therefore the clause met the test under UCC 2-718.

The most recent New York appellate case, *Blackman v. Genova*, 268 A.D.2d 547, 704 N.Y.S.2d 86 (2d Dep't 2000),

found that even assuming that UCC 2-718 applied, the buyer had failed to argue that the amount of the down payment constituted an unenforceable penalty, and thus awarded the deposit to seller. 268 A.D.2d 547 at 548, 704 N.Y.S.2d 86 at 87.

UCC Not Best Analysis

The way the courts have conducted their purportedly Code-based liquidated damages analysis betrays a certain uneasiness. Either they endeavor to evaluate each situation thoroughly under 2-718 (which just widens the counter-intuitive legal chasm between cooperative and real property purchase transactions) or they seem to jump to legal conclusions that complement their “cooperative as real property” instinct, finding 10 percent reasonable (which threatens to produce another potentially dangerous result — questionable liquidated damages law).

At bottom, employing the Code to adjudicate disputes in co-op stock purchase transactions exacerbates doctrinal tension between the market expectation and inclination to view the purchase of a cooperative apartment as a real property transaction and the unduly narrow, form-exalting legal conclusion that cooperative “stock” is merely personal property.

Furthermore, 2-718 necessarily requires individualized judicial scrutiny under which each non-breaching seller either must demonstrate his entitlement to keep the entire “earnest money” deposit or become relegated to collecting only his actual damages. Setting aside the additional burden such tedious litigations place upon our already overtaxed court system, the requisite case-by-case analysis makes co-op purchase contracts, when assessed in the breach, look even less like real property transactions, wherein the defaulting buyer ordinarily is presumed to forfeit that deposit.

In this way, the prevailing adjudicative model completely reverses the customary evidentiary burden and can leave a non-breaching co-op seller

without a good remedy against a less than “earnest” prospective purchaser. Ironically then, “earnest money,” which traditionally has meant that a willing and able buyer has put down a forfeitable deposit to demonstrate his firm commitment to consummating the sale, has become an empty phrase in the cooperative housing milieu.

In short, this author believes that consistency in judicial dispute resolution is essential whether the alleged default arises in the conventional real property context or the cooperative setting. The central object of a typical co-op stock purchase transaction — acquisition of the exclusive right to occupy particular real property — should guide resolution of any dispute arising under the contract documents which memorialize such an agreement.

Traditional Rule Is Best

Applying the traditional deposit forfeiture rule in this context makes sense because most people, lawyers and laymen alike, intuitively view buying into a cooperative corporation as essentially a real estate transaction. *Vermeer Owners, Inc. v. Guterman*, 78 N.Y.2d 1114 (1991). After all, residential “cooperators” do not buy co-op stock expecting dividends. They buy seeking living space. See *In re Estate of Carmer*, 71 N.Y.2d 781, 784-5, 530 N.Y.S.2d 88, 89 (1988) (characterizing cooperative “stock” as capital expenditure for living space rather than ordinary investment security representing interest in ongoing business enterprise). The cooperative share prices reflect the perceived value of the particular apartment to which each stock package corresponds.

Practically speaking, the cooperative stock lacks any real value absent those real property rights that attend the accompanying proprietary lease. See *United States v. 110-118 Riverside Tenants Corp.*, 886 F.2d 514, 517-8 (2d Cir. 1989), cert. denied, 495 U.S. 956, 110 S.Ct. 2560 (1990) (characterizing “stock” in cooperative

corporation as “not freely transferable” and valueless absent “inseparable” proprietary lease to particular apartment). That interdependence arguably makes the shares as unique as the underlying real property, at least when a court is examining the rights and obligations imposed under a share purchase contract which is itself subject to the “real property” subdivision of the Statute of Frauds. *Moloney v. Weingarten*, 118 A.D. 2d 386, 500 N.Y.S.2d 32 (2d Dept. 1986).

Six years after *Silverman* was decided, the Court of Appeals stated, in evaluating the nature of co-op apartments:

Both approaches are overly facile [classifying co-ops as either real or personal property] ... Neither the stock certificate nor the lease, inseparably joined, can appropriately be viewed or valued in isolation from one another. *Nor may a dynamic jurisprudence ignore the manner in which economic affairs are conducted or the perception that the members of society have in conducting their affairs* (emphasis added). *Shor*, supra, 43 N.Y.2d at 151.

The time has come to recognize that in the 30 years since *Silverman* was decided, the courts have come to view the purchase of a cooperative apartment more and more like the purchase of real property. The courts should abandon a liquidated damages analysis under the Code and treat co-op purchase contract disputes just like they would any other involving a real property sale. This would be in accord with the long-standing expectations of the marketplace, and the “perception that the members of society have in conducting their affairs.”

The cooperative share is merely a legal vehicle by which every shareholder reaches the true object of her relationship with the cooperative corporation — the exclusive right to own and occupy a particular apartment.