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Business Judgment Rule: No Free Pass to Board Action

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The past 12 months has been the year unit owner's and shareholders have found cooperative and condominium board of director's kryptonite at the appellate courts. For years, the courts of New York have been rubber stamping board decisions under the shield of the business judgment rule. Whether it be the persuasive facts in this year's crop of co-operative and condominium cases or a change in policy, the appellate courts have been enforcing the corporate documents and determining whether boards have been acting in good faith and with the proper authority and piercing the shield of the business judgment rule.

History of Deference

Twenty-four years ago, in *Levandusky v. One Fifth Avenue Apartment Corp*.,1 the New York Court of Appeals announced that, henceforth, New York courts would apply the business judgment rule, first developed in the context of business corporate law, in cases challenging the decisions and actions of the governing boards of cooperative apartment corporations and condominium associations.

As enunciated in Levandusky, and as the court further explained in 40 West 67th Street v. Pullman,2 the business judgment rule was intended to insulate from court review the myriad of decisions and actions that co-op and condo boards must make in good faith on a daily basis to govern and operate their buildings in the interest of their shareholders and unit owners and for the good of their buildings generally.

Over the years, in applying the business judgment rule, courts have given great deference to board decision-making, and they have routinely dismissed hundreds, if not thousands, of cases brought by disgruntled shareholders and unit owners who have disagreed with or been affected adversely by board decisions. Nevertheless, as the Court of Appeals also made clear in Levandusky and Pullman, the business judgment rule was never intended to be a vehicle for courts to give "rubber stamp" approval for board action that is done without authority, in bad faith, or that discriminates between classes of shareholders or unit owners or singles out individual shareholders or unit owners for disparate treatment.

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It is interesting to note, therefore, that, despite the history of courts affording great deference to board governance, several recent decisions have shown that New York courts appear increasingly willing to give greater scrutiny to cases alleging unauthorized board action, and, in doing so, they are making it clear that the business judgment rule does not give boards a free pass to act in disregard of their governing documents and by-laws or otherwise in disregard of the law.

To be sure, the business judgment rule will still be applied, as Levandusky and Pullman directed, where board decision-making is challenged, but a board is able to meet its prima facie burden to show that it acted in good faith within the scope of authority given in its by-laws, to further the interests of its co-op or condo, and the shareholder or unit owner challenging the board's action is unable to raise a triable issue of fact concerning the board's action.

Rule Upheld

Such was the result in *257 Central Park West v. Abraham*,3 where the record showed that the shareholder's parking license was terminated based on his demonstrated delinquency in timely paying his monthly parking fees, and the shareholder made no persuasive showing that the co-op board had acted beyond its scope of authority, and even "expressly disavowed any claim that the board improperly 'singled [him] out."

Similarly, in 40-50 *Brighton First Road Apartments v. Kosolapov*,4 where a group of shareholders challenged a special assessment imposed by a residential co-op, the court granted summary judgment to the co-op finding that "the broad financial management authority granted to the Board in the bylaws and proprietary lease clearly includes determinations made by the Board, and there is no claim that any part of the funds collected from the special assessment were used for any purpose other than the furtherance of the co-operative's legitimate interests."

Rule Held Inapplicable

However, in cases where the record shows that a board has either clearly exceeded the authority granted in its by-laws or otherwise cannot offer an explanation for a particular decision it has made, New York courts will not hesitate to find the business judgment rule inapplicable to such board action. Likewise, where the record presents triable issues of fact concerning whether the board acted outside the scope of its authority and/or whether the actions of the shareholder or unit owner justifiably triggered the complained of board action, the courts will deny summary judgment and direct that a trial be held to determine whether or not the business judgment rule should apply to the board's action. Several recent cases are illustrative of these trends.

In *Razzano v. Woodstock Owners*,5 the First Department held that the sublet policy of a co-operative corporation violated Business Corporation Law (BCL) §501(c) because the policy allowed shareholders who purchased their shares before October 2002 to sublet, but prohibited shareholders from subletting who purchased their shares after that date. The court further held that because the sublet policy violated (BCL) §501(c), the board's policy was not protected by the business judgment rule.

In *Goldstone v. Gracie Terrace Apartment Corp*.,6 a shareholder suffered extensive property damage from an overflowed water tank above her apartment. The board gutted the shareholder's apartment to clear it of toxic mold and adopted a plan of renovation and repair that necessitated a 50-square-foot reduction in the shareholder's interior apartment space. The board refused to adopt the renovation plan of the shareholder's engineer, which avoided any reduction of square footage in her interior apartment space, contending that her engineer's plan would require the co-op to demolish and rebuild exterior walls, and entailed substantial extra expenses that the board

was under a fiduciary duty to avoid imposing on other shareholders.

The shareholder brought suit seeking damages for the board's breach of her proprietary lease by reducing the size of the apartment "as partitioned on the date of the execution of this lease." She also sought equitable relief to compel the board to follow the renovation plan of her engineer. Although acknowledging that the board's plan to reduce the interior space of the apartment by 50 square feet was a de minimus reduction in total apartment space, the First Department held nevertheless that the board had breached the proprietary lease, that the business judgment rule does not shield cooperatives from liability for breaches of contract, and that the shareholder was entitled to compensable damages for the breach.

The court further noted that, under the circumstances presented, "[a] breach of a tenant's proprietary lease by the cooperative's board of directors may be the best of the options open to the board, but that does not protect it from liability for that breach." On the other hand, despite the probable success of the shareholder's action for breach of contract, she was not entitled to equitable relief. The court held the board's refusal to adopt her engineer's renovation plan would not cause her irreparable harm, and, on a balancing of the equities, that the board's adoption of the plan of its architect was justified, because the claimed impact on her apartment was far outweighed by the expense to the co-op of demolishing and rebuilding exterior walls.

In *Cohan v. Board of Directors of 700 Shore Road Waters Edge*,7 the co-op board imposed a sublet fee on the shareholder. The board claimed that the "sublet policy" recited in the shareholder handbook was an enforceable "house rule." The Second Department determined that neither the proprietary lease, by-laws, shareholder handbook, or "house rules" adopted by the board, substantiated the board's claim. The board had therefore acted outside the scope of its authority, and its assessment of the sublet fee was not protected by the business judgment rule.

In *Linda Tenants v. Spanakos*,8 a commercial landlord commenced a commercial holdover proceeding to recover possession of a parking space provided to the tenant as an incident of the tenant's proprietary lease. The landlord neither alleged nor proved a reason for its decision to terminate the tenant's parking space. The Appellate Term held that the landlord's action was reviewable under the business judgment rule, but that, "in view of the landlord's failure to articulate any basis for the termination," it could not be determined "whether the landlord's actions were 'taken in good faith, and in…legitimate furtherance of corporate purposes,'" and the landlord's petition was dismissed.

As noted above, when the action of a co-op or condo board is not either clearly within or clearly outside the scope of its authority, the courts will find that triable issues of fact exist to determine whether the board's action is protected.

In *Kleinerman v. 245 East 87 Tenants Corp*.,9 shareholders seeking to renovate their apartment alleged that the board and its individual board members condoned the superintendent's solicitation of kickbacks by improperly stopping their renovation work. The First Department held that "issues of fact exist, including whether the board members had knowledge of the superintendent's alleged conduct, whether the co-op corporation stopped plaintiffs' renovations in good faith based on the interests of the co-op, and whether plaintiffs were accorded disparate treatment."

In *Irene David Realty v. Moyal*,10 minority shareholders in a commercial cooperative corporation alleged that the president of the corporation had engaged in self-dealing in connection with the subleasing of certain ground floor premises that two corporations owned by the president leased from the corporation. The minority shareholders complained that the president had improperly participated in the board's vote to approve a sublease between the two corporations and a third party.

In opposition to the minority shareholders' motion for summary judgment, evidence was submitted showing that the sublease was subsequently ratified by a disinterested director following full disclosure of the president's interests. The First Department held that issues of fact had been raised as to whether the sublease had been properly ratified, and, therefore, whether or not the board's action in approving the sublease was outside the protection of the business judgment rule was a triable issue of fact.

In *Wood v. 139 East 33rd Street Corp*.,11 a shareholder alleged that the co-op had breached her proprietary lease and an alteration agreement by stopping work that was proceeding in accordance with her approved renovation plans. The First Department held that, although the contract issue could be resolved without regard to the business judgment rule, whether the board had breached the proprietary lease or whether shareholder had breached the alteration agreement could not be resolved on summary judgment due to conflicting testimony regarding the shareholder's allegedly drilling into her ceiling.

Trials

Recent decisions of the trial courts have likewise held that the board actions complained of in those cases were not ripe for summary judgment and required a trial to determine whether the business judgment rule would apply.

In *Mittman v. Board of Managers of Bayside Plaza Condominium*,12 the court held that the business judgment rule did not protect the board's renovation assessment allocation to the plaintiff unit owner because the rate of assessment exceeded the unit owner's pro rata percentage share of total condominium common interests. However, the board's motion for summary judgment for unpaid common charges was denied because the plaintiff had raised a valid defense, namely, whether the assessment was unjustifiably disproportionate to the plaintiff's ownership interest.

In *Tucciarone v. The Hamlet* on Olde Oyster Bay Homeowners Association,13 the court found that the board's action in denying the plaintiff unit owners all amenities and vehicle access to the condominium grounds for failure to pay certain fines, was done for the purpose of pressuring the unit owners to settle a related action brought by a neighboring unit owner against both the board and the plaintiffs for certain damage to the neighbor's property caused by the plaintiffs' planting of an invasive form of bamboo vegetation.

The court held that whether the defendants had followed proper procedures in imposing the fines was "questionable," and, finding that the defendants' actions were not protected by the business judgment rule, the court granted the plaintiffs' motion for injunctive relief and enjoined the defendants from denying the plaintiffs the use and enjoyment of all amenities and from seeking to collect and enforce payment of any fines or assessments imposed on plaintiffs.

Conclusion

The above review of recent cases shows that New York courts are mindful of the purposes of the business judgment rule and will give due deference to the actions of co-op and condo boards wherever it is clear that the boards have acted within the scope of their authority and in good faith in the interests of their shareholders, unit owners, and their buildings. However, the courts are also careful to scrutinize the actions of boards that either skirt the limits of their authority or that clearly ignore those limits entirely. In the latter cases, the courts do not hesitate to strike down board action that is arbitrary and done without legitimate authority.

As the battle fields equalize, shareholders and owners may be emboldened to challenge board decisions. Although the recent trend favors this scenario, courts will still be properly enforcing the corporate documents and determining whether a board has acted in good faith. At the same time, boards should be acting reasonably and following their corporate documents when making decisions and not expecting to hide behind the business judgment rule.

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ENDNOTES:

1. 75 NY2d 530 (1990).

2. 100 NY2d 147 (2003).

3. 40 Misc.3d 138(A), 980 NYS2d 279 (App. Term, 1st Dept. 2013); see also 1812 Quentin Road LLC v. 1812 Quentin Road

Condominium LTD, 94 AD3d 1070, 943 NYS2d 206 (2d Dept. 2012).

4. 39 Misc.3d 27, 964 NYS2d 396 (App. Term, 2d Dept. 2013) (full disclosure: the author's law firm represented the

petitioner corporation in this matter.); see also Cave v. Riverbend Homeowners' Association, 99 AD3d 748, 951 NYS2d 758

(2d Dept. 2012).

5. 111 AD3d 522, 973 NYS2d 38 (1st Dept. 2013).

6. 110 AD3d 101, 970 NYS2d 783 (1st Dept. 2013); see also Conforti v. The Carleton Regency Corp., 2013 WL 6919413

(N.Y. Sup.).

7. 108 AD3d 697, 969 NYS2d 547 (2d Dept. 2013).

8. 43 Misc.3d 137(A), 2014 WL 1717010 (App. Term, 2d Dept. 2014).

9. 105 AD3d 492, 963 NYS2d 187 (1st Dept. 2013).

10. 107 AD3d 430, 967 NYS2d 41 (1st Dept. 2013).

11. 104 AD3d 620, 961 NYS2d 466 (1st Dept. 2013).

12. 43 Misc.3d 1208(A), 2014 WL 1356102 (N.Y. Sup).

13. 41 Misc.3d 1236 (A), 983 NYS2d 207 (Sup. Ct., Nassau, 2013).

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