New York Law Journal

The State of Cooperative and Condominium Law in 2015

Wednesday, December 30, 2015

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The greatest changes in cooperative and condominium law this past year did not come from the Legislature or from the courts but from the New York Attorney General's office (NYAG). This article will review some of those changes and the most significant appellate cases affecting co-ops and condominiums.

Buyouts and Conversions

With respect to co-op and condominium conversions, NYAG's Real Estate Finance Bureau (REFB) has focused its mission on (1) maintaining and protecting the rent-regulated system and free market tenants in buildings converting to co-op and condominium ownership and (2) increasing and maintaining the number of low and moderate income housing units. As a result, the REFB is shifting its focus away from protecting owners suffering from buying in poorly built newly constructed buildings.

Thus, in early 2015 the REFB heavily relied on a July 9, 1986 internal memorandum setting forth its rules with regard to buyout offers. That memorandum stated that "buy-out offers cannot be accepted by the tenants until the Black Book is out. *There will be no exceptions to this policy—our experience of the past nine months has persuaded us that the only fair, even-handed way of enforcing this policy is not to allow any exceptions.*" (emphasis supplied). This internal memorandum was first disclosed to the public on REFB's website almost a year ago, but it had never been published before nor had it been codified into a formal regulation.

On July 9, 2015, the REFB abolished and replaced the 1986 memorandum. While incorporating some of the policies of the 1986 memorandum, writing, "The policy concerns raised by pre-red herring buyouts are the same now as they were in 1986. As such, the guidance on these buyouts set out in the 1986 guidance document remains in place." However, the memorandum does not provide "guidance" at all. It provides inflexible rules and, as such, runs afoul of the State Administrative Procedure Act (SAPA). Under the 2015 memorandum (M2015), "Sponsor must disclose the buyout offer and the DOL's [Department of Law] position on buyout agreements in the offering literature."

If either the courts uphold M2015 or if the REFB re-issues its principles as a validly promulgated regulation under SAPA, the dynamic in conversions of rent-regulated units to owner-occupied units will be transformed. Under prior law, developers routinely bought out rent-regulated tenants in order to achieve the percentages of converting units necessary to declare a plan effective. Under the new policy, however, those percentages will no longer be available by these means. This new policy has therefore removed from rent-regulated tenants a right worth purchasing and long-term tenants who were counting on such buyouts to finance their move to warmer climates now can't. This REFB policy makes it difficult for an elderly couple in a multi-bedroom apartment to sell their rights to that apartment so that they can downsize to a unit in Florida.[1] The regulated tenants lose the buyout monies and the housing market loses desperately needed units to be sold during this housing shortage. And the overall housing market forces home prices to remain high and unaffordable because of the large inventory of apartments kept off the market.

While the 2015 memorandum is unclear as to precisely when the period begins in which buyouts will come under REFB scrutiny, it appears that, at the very least, any buyout agreement entered during the five months prior to the filing of the red herring is guaranteed to receive REFB disapprobation.

Legalizing an Illegal Rule

Although the attorney general's office first protested that the 1986 and then the 2015 memorandum were legal under SAPA, their violation of SAPA is clear.

SAPA provides for two different kinds of documents. Under SAPA §202-e, there are "guidance documents" and while §202-e regulates their publication, it does nothing to define what constitutes "guidance." Neither does the case law—there is none construing §202-e. However, case law prior to §202-e's 2004 enactment makes clear that a guideline established by an agency is considered to be a rule or regulation requiring filing with the New York Secretary of State in accordance with N.Y. Constitution, Article IV, §8 and SAPA §202 if it is "a fixed, general principle to be applied by [the] agency without regard to other facts and circumstances relevant to the regulatory scheme of the statute it administers."[2]

Since the 1986 and 2015 memoranda both establish inflexible requirements applied by the REFB as a rule of law, neither is valid under this body of law and the REFB must instead comply with SAPA to enact a rule or regulation under SAPA §202.

That process requires submitting to the NY Secretary of State a notice of proposed rule making, for the Department of State to publish in the state register; affording the public normatively a period of 45 days for an opportunity to submit comments on the proposed rule.

It may take litigation to require the Attorney

General's office to follow the law, but until then converting condominiums and the sponsors, tenants and potential buyers will be unjustly harmed as a result of the illegal rule.

Mitchell-Lama Privatization

At the end of 2014, the Court of Appeals handed down *Trump Village Section 3* v. City of New York,[3] which, had it been ruled otherwise, would have made privatizing a Mitchell-Lama cooperative much more expensive for the shareholders. These co-ops are among the very few programs in New York State aimed specifically at assisting the middle class. They are cooperative housing projects that, in exchange for limiting their shareholders to persons who are middle income primary residents of the projects who adhere to certain needs based allocations of apartments, receive tax relief for that period that the project remains in the Mitchell-Lama program, normally 20 years.[4]

Exiting the program is known as "privatization," although, the only thing that is ever "public" about the program is the overseeing the project receives from a supervisory agency (in New York City, either the Department of Housing Preservation and Renewal or the State Division of Housing and Community Renewal) and the resultant real estate tax benefits.

In Trump, the shareholders decided to privatize, following the path of amending the corporation's certificate of incorporation. New York City claimed that this exit from Mitchell-Lama was a "conveyance" and sought over $21 million in recording taxes, interest, and penalties. The city claimed that the privatization constituted a transfer from the old Mitchell-Lama-based corporation to a brand new generic Business Corporations Law corporation. The court ruled that the co-op was not subject to the taxes at all.

Because the apartments in such projects receive tax benefits, privatization frees the apartments from the restrictions on to whom they can be sold and for how much and generally instantly substantially enhances the sales prices of such apartments. For the shareholders, the decision whether to privatize is a decision whether to have the benefits of cheap housing or to have less cheap housing and higher profits in selling the apartment.

Thus the Trump case removed a disincentive to privatization and allowed such complexes to allow their shareholders to realize the full profitability of their investments in their apartments.

Business Judgment Rule

The year 2015 saw new developments and refinements in familiar areas of cooperative and condominium law. One of the most important of these is the business judgment rule—the principle of law that will immunize the decisions of a board of a co-op or condominium from the interference of the courts unless the decision in question is illegal or the result of board members' self-dealing or discrimination.[5]

In *South Tower Residential Board of Mgrs. of Time Warner Center Condominium v. The Ann Holdings,*[6] the First Department subtly adjusts the standard for self-interest on the board. The court wrote, "However, even if, arguendo, plaintiff engaged in some favoritism…, defendant failed to show prejudice therefrom." This is a clear carve out from previous doctrine, but it leaves unclear whether a challenge to a board for violation of the business judgment rule requires showing for any violation that there is both a violation and resultant prejudice.

In *Pomerance v. McGrath,*[7] the First Department ruled on challenges to the exercise of the business judgment rule and in each of them sustained the board's authority. Thus, where a bylaw disallowed the board expending funds above $10,000 for a capital improvement without shareholder assent, the court found the business judgment rule allowed the board the discretion to do a repair regardless of price, without shareholder assent. It also found that the business judgment rule gave the board authority to sue the sponsor. A contrary finding would have been a disaster in New York where many cases attest to endemic poor construction in fresh construction condominiums, saddling the unit owners with the tab for correcting it. Boards must have the discretion to bring such suits.

In a relatively unusual application of the business judgment rule, *Jacobs v. Grant,*[8] the Second Department found in favor of the board's discretion in moving a shareholder's property out of the storage bins to a storage facility after the shareholder refused. The board was moving the property for a building-wide asbestos abatement program. Unsurprisingly, the court refused to find that there was a conversion, as the shareholder had pressed. Surprisingly, the court found that the move of the personal property was within the board's power under the business judgment rule. In other words, allowing for the possibility (sub silentio) that the conduct was actually tortious, the Appellate Division impliedly found that the business judgment rule gave the board the discretion to commit the tort.

That kind of limitation is seen in *Razzano v. Woodstock Owners.*[9] Neither the business judgment rule nor anything else allows a co-op to craft a rule that favors some shareholders over others. In *Razzano,* subletting was limited to those who had purchased their shares prior to a particular date. Since the Business Corporations Law §501(c) requires that all shares in the same class be treated alike, there can be no rule in a cooperative that favors one over another. Thus, the board does not have the authority to discriminate against newcomers in favor of the old guard.

Fees, Fines and Assessments

Intimately associated with the business judgment rule, is the power of a board to use its judgment to impose and assess fees, fines, and assessments. Although in real life the unit owners tend to dispute the facts of their having engaged in conduct that justifies a fee or fine and to dispute the board's justification for imposing an assessment, in the court decisions, the matter is much more about whether the board has the legal authority for these financial matters.

One such dispute was in *Cohan v. Board of Directors of 700 Shore Road Waters Edge,*[10] in which the bylaws would have permitted a fine for an illegal sublet, but the court did not permit the board to impose it. There was no sublet; the disputed occupancy was that of a sister, one the bylaws specifically permitted. Thus, not only did the court reverse the fine, but it also awarded the shareholder her attorney fees.

On the other hand, in *Cave v. Riverbend Homeowners Association,*[11] the Second Department upheld a late fee, making it free from challenge under the business judgment rule.

In *Baxter Street Condominium v. LPS Baxter Holding Co.,*[12] the court wrote, "The condominium board's determination that the assessment was necessary for 'repair' work, which, pursuant to the by-laws, does not require the sponsor's consent or the unit owners' approval, is protected by the business judgment rule." While the Baxter court showed the board's justification, there need be no such showing. And even though Baxter is not explicit in this regard, it is the only proper way of understanding it.

In short, the justification of the board's actions is just a makeweight. Similarly in *40-50 Brighton Road Apartments v. Kosalapov,*[13] the Appellate Term, (2d, 11th, and 13th Jud. Dists.) ascertained that an assessment was made to finance certain work for the co-op and the court refused to grant any significance to the shareholders' arguments that such funds were not actually used for such purposes, but for other corporate purposes. (Note: The authors' firm represented the co-op board in Brighton Road, both at trial and on appeal).

Of great importance is *Gabriel v. Board of Mgrs. Of the Gallery House Condominium,*[14] in which the court acknowledged the board's power to impose fines, as set forth in a set of bylaws, but "the imposition of fines in the amount of $500 per day for violations of the guest policy is confiscatory in nature… The board cites no persuasive authority to support the imposition of such a hefty fine." Boards' counsel face this question daily. Clients routinely ask, "How severe a fine can we impose?" Their inclination is generally to make the fine so severe as to make it prevent the conduct sought to be discouraged, but if the number is too high, the court allows no fine at all. While there are cases that say when it is too much, there are none that provide any calculus for determining what is allowable. Since excessively small fines don't accomplish anything, it is a difficult balance to strike.

In Sum

This has been a very important year in the co-op and condominium world, especially for the middle class and rent-regulated tenants. The Court of Appeals has now allowed low-to-moderate income buildings to privatize and avoid a significant tax payment. At the other extreme, the Attorney General's office has frozen rent-regulated tenants' and sponsors' ability to complete the buyouts of apartment leases, keeping fewer units from hitting the market and making it more difficult for New Yorkers to buy homes. At the Appellate Division, the courts have cleared up some debated issues on treating new owners differently than existing owners, while providing co-ops the power to use self help for recalcitrant owners who refuse to move storage items, and strictly construing the corporate documents when applying the law.

ENDNOTES:

1. Peter D. Salins and Gerard C. S. Mildner, "Scarcity By Design" (Harvard University Press, Cambridge, Massachusetts: 1992) p. 29.

2. *Matter of Sunrise Manor Nursing Home v. Axelrod, 135 A.D.2d 293, 296, 525 N.Y.S.2d 367, 369 (3d Dept. 1988),* quoting *Matter of Roman Catholic Diocese of Albany v. New York State Dept. of Health,* 66 N.Y.2d 948, 951, 489 N.E.2d 749, 750, 66 N.Y.S.2d 948, 951 (1985).

3. 24 N.Y.3d 451, 24 N.E.3d 1086, 999 N.Y.S.2d 822.

4. Private Housing Finance Law §35(2).

5. *Cohen v. Kings Point Tenant Corp.*, 126 A.D.3d 843, 6 N.Y.S.3d 93 (2d Dept.).

6. 127 A.D.3d 485, 8 N.Y.S.3d 38.

7. 124 A.D.3d 481, 2 N.Y.S.3d 436.

8. 127 A.D.3d 924, 6 N.Y.S.3d 623.

9. 111 A.D.3d 522, 975 N.Y.S.2d 38.

10. 108 A.D.3d 697, 969 N.Y.S.2d 547 (2d Dept. 2013).

11. 99 A.D.3d 748, 951 N.Y.S.2d 758.

12. 126 A.D.3d 417, 5 N.Y.S.3d 52.

13. 39 Misc.3d 27, 964 N.Y.S.2d 396. Full disclosure: Adam Leitman Bailey, P.C. of whom these authors represented the cooperative board and prevailed both at trial and on appeal.

14. —N.Y.S.3d—, 130 A.D.3d 482, 2015 WL 4112882, 2015 N.Y. Slip Op. 06019.