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A Path to Follow

'Spiegel' Court Clarifies Co-op Subletting Rights

Amidst all of the recent excitement in the co-op housing community over the *Pullman*¹ decision, another ruling (decided the very same day) may have been overlooked. This decision, *Edith Spiegel v. 1065 Park Avenue Corporation*, 2003 NYSlipOp 14019, is yet another case dealing with the applicability of §501(c) of the Business Corporation Law (BCL) to cooperative housing corporations.

Over the past decade, §501(c) has been ignored, applied, amended and even misapplied, and the courts, little by little, have attempted to clarify what is meant by the section, and to whom it is applicable.

Background

Before 1986, §501(c) stated that "shares of the same class be equal in all respects to every other share of the class." In *Fe Bland v. Two Trees Management Co.*,² the court held that the flip tax in question, which differed depending on whether the assignor was a purchaser from the sponsor or an outsider, and whether the assignor had been an owner for at least five years, violated §501(c).

The Legislature acted swiftly, and the very next year the section was amended such that unequal flip taxes were permitted if provided in the cooperative's proprietary lease.³

As analyzed in a 1998 Law Journal article,⁴ three years after *Fe Bland* and after the subsequent amendment to §501(c), the Appellate Division, First Department, in *McCabe v. Hoffman*⁵ held that subletting fees imposed by a co-op board that were based on the amount of rent collected from the subtenant did not violate §501(c), for the section did not apply to subletting. In effect, the court held there were two separate and distinct aspects to owning a co-op apartment: corporate attributes (rights for voting, transferring shares, etc.) and real property attributes (rights regarding subletting, occupancy, etc.), which confirmed the position taken by many attorneys.

In 1997, the First Department decided the *Wapnick*⁶ case, and its words sent shock waves through the co-op community. The case revolved around provisions in the proprietary lease and by-laws giving preferential treatment to original purchasers (i.e. those who bought their shares from the sponsor at the time of conversion) with respect to the fees and consent requirements relating to the shareholder's ability to sublet or sell their cooperative apartment. The *Wapnick* court, which never once mentioning the *McCabe* decision, held that:

While the section 501(c) amendment carved out a specific exception with respect to a flip tax on the sale of shares, if appropriately provided for, it in no way changed the statute's general mandate that shares of the same class be treated equally. Defendant's contention that variations in fees for sublet-

ting and assignment (as opposed to sale of shares) are permissible under the statute so long as appropriately provided ... [in the proprietary leases, occupancy agreement or offering plans] ... is therefore incorrect.

The implications of *Wapnick* were extraordinary. Clearly it brought into question the validity of all subletting fees based upon anything other than the number of shares owned by the subletting tenant-shareholder. But more importantly, it also brought into question the validity of any differential treatment of shareholders, even holders of unsold shares.

The overwhelming majority of cooperatives require consent if a shareholder wishes to sublet, but allows a holder of unsold shares the right to sublet without board approval and without payment of any fee. Did *Wapnick* really mean to invalidate all such provisions?

'Susser'

It was not long after *Wapnick* that the issue of preferential treatment of holders of unsold shares was before the First Department.

In *Leslie Susser v. 200 East 36th Owners Corp.*,⁷ the court held that the exemption from subletting restriction and fees in favor of holders of unsold shares was permissible. The court rationalized that:

The exemption of the sponsor, as holder of unsold shares, from defendant cooperative corporation's otherwise applicable strictures as to subletting is, moreover, justified by obligations imposed upon the sponsor that are not shared by other shareholders. The sponsor must provide renewal leases to non-purchasing tenants who remain in possession pursuant to a non-eviction plan ... and the discharge of that obligation would be rendered difficult, if not impossible, by subjecting the sponsor to restrictions on subletting applicable to other cooperative proprietary leaseholders. ... Our determination in *Wapnick* ... is not to the contrary since in that case the differential treatment involved affected similarly situated tenant shareholders, and, accordingly, could not have been justified by the considerations implicated herein.

But what of original purchasers? It is not unusual in a cooperative to find that the sponsor, in order to entice current tenants to purchase their apartment in newly converted buildings, places in the offering plan, by-laws and/or in the proprietary lease that a shareholder who purchases from the sponsor on conversion has the right to sublet their apartment without consent of the board. Often, the only consent required is that of the managing agent, not to be unreasonably withheld.

Are the rights given to these shareholders, though preferential, permitted under §501(c) due to the holding in *Susser*?

The answer can be found in the recent *Spiegel* deci-



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sion. Plaintiff was rental tenant of an apartment at 1065 Park Avenue in Manhattan and when the building converted to cooperative ownership, she purchased the apartment from the sponsor. Her proprietary lease provided:

As a privilege of the original issuance of the Lessor's shares, a lessee who is an original purchaser (but not his successors or assignees) may assign this lease and sublet the apartment without the consent of the Directors or shareholders as provided in paragraphs 15 and 16 but with the consent only of the Lessor's then Managing Agent which may not be unreasonably withheld. If the then Managing Agent refuses to consent for any reason whatsoever, such Lessee may apply for consent to the Directors of the shareholders provided in paragraphs 15 and 16 hereof.

Plaintiff lived in the apartment for many years, but then purchased another apartment in the same cooperative, and moved into her new apartment.

She sublet her original apartment for over a decade until 2000, when the building's managing agent rejected the renewal of the sublease she had with the occupant. The managing agent claimed there were numerous reasons why the subletting arrangement was being denied, and less than a month later, Ms. Spiegel began an action against the cooperative (and the managing agent) seeking a declaratory judgment that she was entitled to continue to sublease her apartment.

The defendant's motion for summary judgment dismissing the complaint based upon §501(c) was rejected by the court, which noted

that the cooperative did not plead as an affirmative defense the question of whether §501(c) of the BCL required that the court rule that plaintiff's rights regarding subletting be disregarded because they were preferential in nature.

The court also held that plaintiff's remedy for any unreasonable withholding by the managing agent of consent to the subletting was not judicial intervention, but rather an application for consent to the board or the cooperative's shareholders, as outlined in the lease (and the parallel provision of the by-laws).

On appeal, the Appellate Division, First Department, vacated the trial court declaration, and held that the lease and by-law provisions in question, which created a separate set of rules for subletting by original purchasers, was a violation of §501 (c) of the BCL.

The appeals court also acknowledged there was a question as to whether the cooperative should be estopped from asserting the illegality of the provision of the lease, or that it had waived its rights to do so.

However, the court noted that the defense of illegality is not waived by a failure to affirmatively plead it in an answer.⁸ Further, the court held that neither waiver nor estoppel based upon the cooperative's conduct be relied upon to enforce corporate documents which are contrary to public policy. Thus, the fact that other original shareholders were subletting, or that the corporation knew when plaintiff purchased the second apartment that one of them would be sublet, or that the cooperative had allowed plaintiff to sublet for over a decade does not act to estop the cooperative from claiming that the subletting was against public policy.⁹

The *Spiegel* decision is critical to many cooperatives that have sat back

and allowed original shareholders, given the right to sublet in their proprietary lease and in their by-laws, to take advantage of the more lenient subletting provision.

Not willing to be the test case, many co-ops have allowed their original shareholders to sublet without interference. Now those same co-ops fear that if an action is brought, the original shareholder will interpose the affirmative defense of waiver or estoppel, based upon the many years that the cooperative allowed the subletting without adherence to its rules.

These cooperatives now have a path to follow. In *Spiegel*, the Court of Appeals has made it clear that provisions regarding original shareholders are not exempt from §501(c), and further, that a cooperative corporation may bring an action to compel such shareholder to adhere to its subletting rules, without the fear of dismissal based upon a claim of waiver or estoppel.

(1) *40 West 67th Street Corporation v. David Pullman*, 2003 WL 21057407. 2003 NYSlipOp. 14001, which in essence held that RPAPL 711 does not require judicial review when a cooperative corporation evicts a tenant for objectionable conduct, provided there is no violation by the board of the "business judgment rule."

(2) 66 NY2d 556, 498 NYS2d 336 (1985).

(3) The phrase "proprietary lease" as used herein also includes occupancy agreements.

(4) Howard Schechter, *Major Changes in Management and Operations of Cooperatives?*, March 23, 1998, NYLJ 54, col.4.

(5) 138 AD2d 287, 526 NYS2d 93 (1st Dept. 1988).

(6) 240 AD2d 245, 658 NYS2d 604 (1st Dept. 1997).

(7) 262 AD2d 197, 692 NYS2d 334 (1st Dept. 1999). Notwithstanding this holding, it is not clear where such exemption exists in §501(c). Further, although the court's rationale might apply when there are statutory (e.g. rent control) tenants, it seems to fall short when the sponsor's tenants are non-statutory, free market tenants.

(8) This is the general rule, and may not be true where its interposition takes the other party by surprise (CPLR 3018[b]).

(9) The court also took note of the fact that the lease contained a "no waiver" clause.