

Fiduciaries In Co-ops And Condos

*Directors, shareholders, board members, attorneys...
who owes a duty to whom?*

BY ANDREW P. BRUCKER

THE CONCEPT of the fiduciary is undoubtedly as old as man. In commerce, the law books are full of cases involving fiduciaries. But to what extent do those concepts translate into the world of cooperative housing corporations and condominium associations, a man-made concept of the 20th century? The following is an attempt to review not only the basic definition of "fiduciary" and "fiduciary duties" but to also outline just who, of all the characters in the typical co-op/condo roster of employees, consultants and professionals, is considered a fiduciary.

A simple definition of a fiduciary relationship is found in "The Restatement of Law, Second, Trusts," which states that "a person in a fiduciary relation to another is under a duty to act for the benefit of the other as to matters within the scope of the relation" (Section 2). Later in the treatise, the definition is somewhat broadened and states that a fiduciary relation also exists when one party is under a duty to give advice for the benefit of another (Section 874).

There are two other phrases that are often used in discussions relating to fiduciaries. Often the term "trustee" is used for the fiduciary,

but this is only in the context of property being held by one for the benefit of another. For example, if management were holding a reserve fund of a co-op in its own name rather than in the co-op's name (a course of action which is highly undesirable, but nevertheless still exists), management would be a trustee and this sort of fiduciary has more intensive duties than other fiduciaries. In addition, a relationship may be "confidential" in nature, but does not rise to the level of fiduciary. The best example of this might be the physician and patient or, in the context of co-ops and condos, the relationship between the housing company and its payroll company.

Putting aside these two relationships, the most obvious and most litigated fiduciary relationships are between the directors of the co-op and the shareholder, and between the members of the board of managers and the condo unit owner.

Directors and Officers

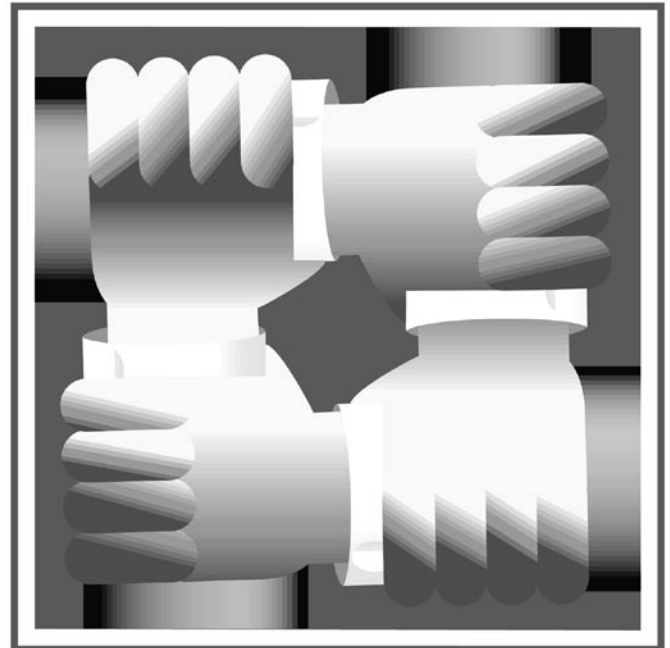
Under §717 of the Business Corporation Law (BCL), directors of a corporation are under a duty to exercise due care and to act in good faith. The same criteria holds for members of the board of managers of a condo. The courts of New York (dealing predominately with non-co-op corporations) often held that the directors owed a duty measured in terms of a standard of care, skill and diligence which ordinarily prudent persons would use under similar circumstances in the conduct of their own affairs.¹ This was often criticized in the business world, however, for it might discourage outside directors from serving

(often for minimal compensation) if they had to assume the same responsibility they assumed in dealing with their own business. Therefore, in 1977, the BCL was amended, and the standard was changed.

Now, under §717(a), the law requires that directors must discharge their duties in good faith and with the degree of care which an ordinarily prudent person in like position would use under similar circumstances. The purpose of the change was to allow a court to view the director's duty of care relatively, depending on many factors, including whether the director was an outsider or not, or whether the director functioned only as an advisor, as opposed to someone intimately involved in the detailed day-to-day operations of the corporation.²

Interestingly, this change was made for commercial corporations. The present reality in America is that corporations very often have outside directors, and without such protection, an individual would think twice before serving on a board. However, the change has also helped co-op (and condo) board members who often have their own professions and jobs, and serve their housing company only a few hours per month.

It should be noted that the standard of care for directors is similar to the standard for officers. However, the BCL grants the director an additional right. A director may also rely on the committee on which he or she does not serve. Though not often found in co-ops



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(or condos), committees are at times created by a housing company board if there is a project that is complicated and the review is better placed in the hands of the few board members who have the background and time to complete a thorough review. The board (under the BCL) has the right to give authority to the committee (consisting of board members only) to act on behalf of the board and approve, or disapprove, the proposal.

Prior to 1977, the directors had only a limited right of reliance. However, the current §717 of the BCL creates a presumption that the director acted properly if the director relied in good faith and with the degree of care required upon certain information, opinions, reports and statements. Therefore, the director need no longer have active involvement in all details of the company's administration in making his or her determination. A director can now rely on the information if presented by (i) a corporate officer (or employee) if the director believes the person(s) is reliable and competent; (ii) an attorney, accountant, or other person who the director believes has expertise in that matter; or (iii) a properly authorized board committee on which he or she does not serve. Reliance is not a shield from liability, however, if the director has any knowledge that puts the information, or those who prepared it, into question.³

Is it possible that a co-op (or condo) board, due to the unique circumstances of a housing company, might owe a further fiduciary duty to its shareholders above and beyond the duty of directors in commercial businesses? Does the unique status of shareholders in a co-op, as a tenant and, in effect, a co-owner of the building, somehow require more from the board of the housing company?

In *Bowers v. Riverview Tenant Corp.*⁴ a situation arose which today is not uncommon. The Board of Riverview decided to undertake major renovations. A number of shareholders objected, and claimed that the board did not have authority to undertake those renovations without approval of the shareholders. The shareholders petitioned the corporate secretary for a special shareholders meeting to vote on the renovations. As one might expect, the board refused to hold the special meeting and to allow such a vote, claiming that it had every right to undertake the renovations. The court correctly rejected the shareholders' argument and dismissed their complaint. However, the court opined that

Acting for the residents collectively, by definition, includes the minority shareholders as well. Although [the court finds] that the Board's failure to call a special stockholders meeting as required by §212 of the by-laws is not legally actionable, its decisions not to hold such a meeting, where 25% of the stockholders had petitioned for one, is undemocratic. This is so because it fails to

take into consideration the concerns of at least some of the building's residents. Even though [the court finds] that ultimately the decision to make improvements falls within the authority of the Board, the purpose of this special shareholders meeting is to give the minority shareholders an opportunity to be heard and to attempt to persuade the Board to do otherwise.... The views of the minority shareholders, whether legitimate or not, are entitled to be voiced and debated so that when the board deliberates, it acts for the collective benefit of the building's residents.

Has this court decided that the BCL should have separate provisions for co-ops and condo? Has the court decided that tenant-shareholders in co-ops have more power than in commercial corporations? Probably not. In all likelihood,



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the court hoped to provide a road map to this and all other co-ops (and condos) for the smooth operation of the housing company. Clearly the bylaws and the BCL provide that the board must make these types of decisions, and the consent of the shareholders is not required. But, as obviously noted by the court, harmony in a co-op and the law are not always the same. A lack of communication with the shareholders is never a good idea and simply adds fuel to the fire created by a controversial decision by the board.

Boards traditionally hire management to oversee the operations of the co-op or condo. Management's duties usually include paying all expenses, collecting all maintenance, supervising staff, managing problems of those living in the building, etc. Due to the nature of this relationship, and the trust and power given to management, one might believe that management owes a fiduciary duty to all of the shareholders (or the condo owners). However, based upon a recent decision, *Caprer v. Nussbaum*,⁵ that does not seem to be the case.

In a prior decision, *Board of Mgrs. of Fairways at N. Hills Condominium v. Fairway at N. Hills*,⁶ the court stated that a fiduciary in

the context of condominium management is one who transacts business, or who handles money or property, which is not his own or for his own benefit, but for the benefit of another person, as to whom he stands in a relation implying and necessitating great confidence and trust on the one part and a high degree of good faith on the other part.

In *Caprer*, the court reviewed the bylaws of the condominium and noted that they gave the board the right to delegate certain powers to management, such as collection of common charges, overseeing staff, purchase of insurance, making repairs, operation and maintenance of common elements, etc. Thus, according to the court, there was certainly a fiduciary relationship between the board and management. However, according to the court, since management did not hold the personal funds of individual unit owners or act on their behalf, no fiduciary duty flowed directly from management to the unit owners (though, interestingly, the court did agree that management was responsible for the common elements, which is owned in the aggregate by the unit owners).

Notwithstanding this decision, the court held that management could still be held liable (pending a determination by the court when the case was ultimately heard). The court in *Caprer* held that since one of the other defendants (who was an individual board member) was being sued for a breach of fiduciary duty, management could be held liable for aiding and abetting a breach of fiduciary duty. One who aids and abets a breach of a fiduciary duty is liable for that breach as well (even if he had no independent fiduciary obligation to the injured party), if the alleged aider/abettor rendered "substantial assistance" to the fiduciary in the course of affecting the alleged breach of duty.⁷

The Accountant

There seems to be a similar answer when one considers whether the co-op (or condo's) accountant is a fiduciary. As a general rule, accountants are not fiduciaries to their clients (i.e., the co-op or condo), and thus would not be a fiduciary to the shareholders or unit owners.⁸ However, if the accountant takes on other roles, such as where the accountant takes on the direct job of managing his client's investments, the relationship might be heightened to one of fiduciary. This is rarely the case in co-ops and condos, for if anyone takes on that role (other than the board), it is often management.

Notwithstanding the fact that the accountant is not a fiduciary, if it can be demonstrated that the accountants had knowledge of a board's breach of its fiduciary obligations, then the accountants may be held liable for aiding and abetting the breach by the board members. Thus, for example, if the accountant of a housing company had knowledge that the reserve was being used

by the board to invest in common stock, and this was held to be a breach of the board's fiduciary obligations, the accountant might be held liable for the breach as an aider or abettor. Likewise, if the board members had been warned that the cooperative was in violation of the so-called 80-20 rule of §216 of the Internal Revenue Code, and nevertheless the board and the accountant ignored the problem and continued to distribute statements to the shareholders in regard to the deductibility of the shareholders' portion of their annual maintenance, the accountant would be held liable for the breach as if it were his own.

The Attorney

Near and dear to us all is the role of the attorney in regard to her housing company client. The attorney for a housing company is retained by the board, and as such, any claims brought against the attorney must be brought by the board. The attorney has no direct relationship with the shareholders (or unit owners, in a condo), and an action by them should be dismissed. But a claim by the board on behalf of the cooperative corporation or the condominium association for a breach of fiduciary duty is inappropriate. Courts have held that such claims should be brought as legal malpractice instead.⁹

However, one must consider all circumstances surrounding the services rendered by the attorney. It is possible that given certain facts, the attorney may take on a different role other than an attorney. For example, if the attorney for a housing company should be holding money on behalf of the housing company, he may be deemed a fiduciary. And, of course, as is the case for all the non-fiduciaries, if it is found that they are aiding or abetting the breach of duty of any fiduciary, the attorney will also be held liable.

The Sponsor

A central figure in any cooperative or condominium is the sponsor. The sponsor is subject to the Martin Act,¹⁰ which in essence requires that the sale of any cooperative or condominium unit must be made by an Offering Plan (subject to the review of the Attorney General's office) and such offering must comply with certain procedures (e.g., escrow requirements). But is the sponsor a fiduciary?

The sponsor of a cooperative or condominium plan is not a fiduciary.¹¹ In fact, if a sponsor makes false statements in an offering plan, a purchaser of a unit may not bring an action against the sponsor. As noted recently by the Supreme Court in Nassau County, the Attorney General has "sole and exclusive jurisdiction to prosecute sponsors who make false statements in offering plans."¹² Notwithstanding this statement (which has long been a mantra by lawyers for years),¹³ the same court confirmed that a common-law fraud claim may be available against the sponsor. The

court warned, however, that "while the Martin Act does not preclude an action for common-law fraud, a private plaintiff may not through careful or artful drafting of a complaint assert a cause of action to redress the wrongs...given over to the [Attorney General] under the Martin Act."

But what of actions by the sponsor after the conversion? After a sponsor declares the plan effective and units are sold, it is very common for a sponsor to retain the right to sit or place designees on the board. In fact, for a short period, it is not uncommon for a sponsor to control the Board of Managers (or Board of Directors). In this role, the sponsor is not protected by the Martin Act. Though the sponsor cannot be sued by unit owners for misleading statements in his Offering Plan, he certainly may be sued for breaching his fiduciary obligations as a board member. The different role means different obligations.

Yet sometimes the roles overlap. The court in *Hamlet on Olde Oyster Bay*¹⁴ wrestled with a situation whereby the Offering Plan disclosed that a certain restaurant lease would be signed by the board after the conversion, which is precisely what took place, when the sponsor-controlled board signed the lease which was described in the Plan. The court dismissed the claim of breach of fiduciary duty based on fraud since there was disclosure in the Plan, and the plaintiffs could not claim they were unaware of the agreement.

Other Shareholders

Although fiduciaries are typically in a position of trust, such as a director of a cooperative corporation, this need not be a requirement. In a number of cases, it has been held that in certain circumstances, shareholders may have a fiduciary duty to other shareholders. In one such case,¹⁵ the court held that because the power to manage the affairs of a corporation is vested in the directors and majority shareholders, they are cast in the fiduciary role of "guardians of the corporate welfare." The court further stated that they must undertake their actions in good faith, and not for the aggrandizement or undue advantage of the fiduciary to the exclusion or detriment of the shareholders. All shareholders, majority and minority, must be treated fairly. But just how far can this be taken?

In one case, *Seif v. 72 Horatio Street Owners Corp.*,¹⁶ a small cooperative consisting of eight units amended the proprietary lease to create a "flip tax" (when all seven units owned by resident shareholders voted for the change). The flip tax only applied when there was a sale by an estate. Needless to say, the eighth unit (which did not vote on the resolution) was owned by an estate. The court held that the flip tax was invalid on procedural grounds, but stated that even if procedurally proper, the flip tax would have been invalid. Even though §501(c) of the Business Corporation Law allows flip taxes which vary in fees and charges, this court took the position that this

flip tax was subject to good faith and that the shareholders should be treated "fairly."

This reasoning (and the thought that co-op shareholders or condo unit owners owe each other a fiduciary duty) can be dangerous. What if a co-op which does not permit dogs suddenly passes (by way of a shareholder vote) an amendment to the proprietary lease that provides that dogs are allowed? Is this fair to shareholders who purchased their units in reliance upon the "no dog" policy? A director has always been thought of as a fiduciary due to his position, and he is held to a higher standard. Are unit owners in housing companies now to be held to some higher standard? Only time, and the courts, will tell.



1. New York Business Entities, White, SB717.01.

2. Revisers' Notes §717 (7th Rep. 1963).

3. *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264 (2d Cir. 1986); *Kimmell v. Schaefer*, 89 N.Y.2d 257, 652 N.Y.S.2d 715, 675 N.E.2d 450 (1996).

4. 3/31/94 N.Y.L.J. 32, Col. 4.

5. 825 N.Y.S.2d 55, 2006 N.Y. Slip OP. 07443 (2d Dept. 2006).

6. 193 A.D.2d 322, 603 N.Y.S.2d 867 (2d Dept. 1993).

7. *Wechsler v. Bowman*, 285 NY 284, 290, 34 NE2d 322 (1941).

8. *Friedman v. Anderson*, 23 A.D.3d 163, 803 N.Y.S.2d 514 (1st Dept. 2005).

9. *Weil, Gotshal & Manges, LLP v. Fashion Boutique of Short Hills, Inc.*, 10 A.D.3d 267, 780 N.Y.S.2d 593 (1st Dept. 2004).

10. GBL Article 23-A.

11. *Board of Mgrs. of Acorn Ponds at N. Hills Condominium I v. Long Pond Investors*, 233 A.D.2d 472, 650 N.Y.S.2d 987 (2d Dept. 1996); *Caprer*, supra.

12. *Hamlet on Olde Oyster Bay Home Owners Association, Inc. v. Holiday Organization Inc.*, 8/17/06 N.Y.L.J. 23, col. 3.

13. "There is no right to private actions under the Martin Act."

14. *Hamlet*, supra.

15. *Alpert v. 28 Williams St. Corp.*, 63 N.Y.2d 557, 473 N.E.2d 19, 483 N.Y.S.2d 667 (1984); See also *Tierno v. Puglisti*, 279 A.D.2d 836, 719 N.Y.S.2d 350 (3d Dept. 2001).

16. 2/6/02 N.Y.L.J. 18, Col. 5.