

## REAL ESTATE Board of New York

ALM

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# The Power Of Cooperative Boards

*Appellate court decides not to interfere with management prerogative.*

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**I**N A RECENT CASE, the Appellate Division once again grappled with the question of just how much power is in the hands of a board of directors of a housing company. The case, *Horwitz v. 1025 Fifth Avenue*, 7 A.D.3d 461, 777 NYS2d 482 (1st Dept. 2004), found that the cooperative's board of directors had wide-ranging powers that are immune from judicial review. The facts of the case are quite interesting and unique, and should be reviewed, for the ruling seems to move the power of the board of a housing company to a new level, and further, the ruling may even expand board power to situations previously thought to be beyond a board's control.

The plaintiffs (husband and wife) purchased their 11th-floor Fifth Avenue cooperative apartment in January 2000. The building had been constructed in 1954 as a cooperative, and has several setback

terraces, many of which, including the plaintiffs' apartment, have had awnings, probably dating from the opening of the building. The only reference to awnings in the cooperative's offering plan states as follows:

#### VENETIAN BLINDS OR SHADES:

The Builders will supply one shade or Venetian blind of uniform color for each window. All other shades, Venetian blinds or awnings are to be supplied by Purchasers to conform to standardized designs adopted for the entire building.

Interestingly, the husband had moved into the building as an infant in 1955 and had grown up in the 12th-floor apartment immediately above the apartment that he and his wife purchased in 2000. The husband testified that he had observed an awning over the 11th floor terrace all during his childhood and young adulthood, and had seen a replacement awning being installed about 20 years ago. To this, there was no dispute. The husband, as executor of his mother's estate, sold the 12th-floor apartment and thereafter, with his wife, purchased the apartment immediately below, which had a large terrace with an awning approximately 30 feet long. The events that are the subject of the lawsuit began about four months after plaintiffs purchased their apartment.

The purchaser of the 12th-floor apartment (immediately above the plaintiffs') performed extensive alterations to his apartment, which ultimately included installing several through-the-wall air conditioning/heating units. A house rule first codified in 1985 required new shareholders to replace window air conditioners with through-the-wall units unless a radiator or other obstruction made it impossible to do so. This rule was subsequently included in later versions of the house rules revised in 1994, as well as in subsequently updated house rules adopted in 1995.

The board was advised by the managing agent that the 12th-floor shareholder's alteration plans had been approved by the cooperative's architect, but that that shareholder could not comply with the air conditioner house rule because plaintiffs' awning blocked through-the-wall installation. The board reviewed its proprietary lease and house rules concerning awnings. The house rules, dated June 15, 1994, and attached to plaintiffs' proprietary lease provided as follows:

No awnings, windows, window guards or screens shall be used except such as have been approved in writing by the Lessor. Any window decoration deemed objectionable by the Lessor shall be changed.

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Updated house rules adopted in March 1995 tracked the foregoing provision. A prior version of the house rules appended to a 1986 proprietary lease for plaintiffs' apartment omitted the written consent requirement, stating only that "No shades, Venetian blinds, awnings or window guards shall be used except such as shall have been approved by the Lessor."

There was no evidence in the corporate records that either plaintiffs or their predecessors had ever sought or obtained consent (written or otherwise) to install any awning. Moreover, the house rules included a provision that the board could revoke any prior approval given for good and sufficient reason. The cooperative's board, exercising its business judgment, determined that the 12th-floor shareholder's right/obligation to install through-the-wall air conditioners trumped plaintiffs' merely permissive ability to maintain the awning.

At the board's direction, the managing agent sent plaintiffs a letter advising that the awning had been installed in violation of the house rules, that it obstructed the upstairs neighbor's ability to install his through-the-wall air conditioners, and that plaintiffs should remove it and repair any damaged bricks in the building's façade.

After a flurry of back and forth correspondence, plaintiffs failed to remove the awning, and the attorney for the 12th-floor shareholder ultimately requested that the board enforce the house rules so that his client could install the units. When direct discussions between plaintiffs and the 12th-floor shareholder failed to resolve the issue, the cooperative, concerned that the upstairs shareholder might commence litigation against the cooperative, served a predicate notice to cure under the proprietary lease. Plaintiffs commenced their action for declaratory and injunctive relief.

The cooperative's proprietary lease included the standard provision that the cooperative had the power to establish, amend or repeal house rules from time to time; that the proprietary lease was subject to the house rules; and that upon receipt of the house rules, the rules bound the shareholder, his family, guests, employees and tenants. Additionally, the proprietary lease stated: "Without limiting the generality of the foregoing, such house rules may regulate and control use of any roof or terrace appurtenant to the apartment, and may require the Lessee to keep such roof or

terrace clean and free from ice and snow ...." Significantly, the proprietary lease also contained a broad no-waiver provision that the First Department ultimately held to be dispositive.

### Arguments

Plaintiffs' theory of the case posited a conspiracy between the managing agent and the 12th-floor shareholder, premised on the fact that the upstairs shareholder was the president of a company that did work on other buildings managed by the agent. In furtherance of their fraud and conspiracy theme, plaintiffs alleged a host of technical and/or procedural irregularities with the upstairs neighbor's alteration plans, the manner in which the plans were reviewed by the managing agent and the cooperative's architect but not by the board, and with the upstairs shareholder's application to the Department of Buildings (DOB) for a work permit. Among other things, plaintiffs argued that the architect had never reviewed and approved any plans that depicted the through-the-wall installations.

Plaintiffs attempted to subpoena the upstairs neighbor and his attorney for depositions and documents (concerning the 12th-floor shareholder's alteration), as well as the cooperative's managing agent, claiming that the previously deposed cooperative vice president was insufficiently knowledgeable. Plaintiffs' attempts to require such depositions were rejected by the court.

The cooperative moved for an order granting summary judgment dismissing the amended complaint, on the ground that its decision to require removal of the awning to permit the installation of the through-the-wall air conditioners by the 12th-floor shareholder was protected by the "business judgment rule." There was no internal obstruction that prevented the installation, the awning had been installed without consent, and, in any event, even if consent had been given, the board could revoke it for cause and the through-the-wall air conditioning rule provided such cause. The proprietary lease's no-waiver clause precluded any argument that the cooperative had waived its ability to enforce the awning consent rule now, even 50 years after the first awning had been installed.

Plaintiffs cross-moved for summary judgment on their amended complaint, raising their conspiracy theory for the charmed third time. Plaintiffs argued that

it was the cooperative, not they, who had breached the proprietary lease, by improperly delegating authority to review and approve the 12th-floor shareholder's alteration plans to the managing agent and engineer. Moreover, the engineer had never reviewed and approved plans that included the proposed through-the-wall installation, they claimed. The cooperative's 1996 house manual of procedure provided that the board could only delegate ministerial issues to management, not substantive issues such as review and approval of alteration plans.

Plaintiffs also argued that the awning was an appurtenance to the building and that the proprietary lease assigned responsibility for maintenance of the building's façade to the cooperative. Thus, not only was the demand to remove the awning and repair any damaged bricks "ultra vires"; it was also "impossible" for plaintiffs to comply because façade work required a permit from DOB that required the cooperative's signature. Plaintiffs also contended that they were not in violation of the house rules concerning awnings because they had not installed the awning, and the prohibition of "use" of an awning without prior written consent meant installation of an awning without written consent.

Plaintiffs further argued that when the awning was originally installed, no consent was required. They argued that the purpose of the house rule was only to require standardized awnings, citing the offering plan language quoted above and the fact that there was no evidence of any written or other consent to any awnings in the building over its 50-year existence. Plaintiffs went on to argue that there was no rule against their simply "maintaining" the awning (the cooperative responded that this semantics-based argument was meritless: "use" included installation and maintenance of the awning). Plaintiffs also contended that the through-the-wall air conditioning requirement did not apply to the 12th-floor shareholder's units because his units doubled as heaters.

### Plaintiffs' Motion

The motion court granted plaintiffs' cross-motion for summary judgment in part, to the extent of declaring that plaintiffs were not in violation of their proprietary lease; that they had a "license" to maintain the awning; and that the predicate notices served were defective and the cooperative was enjoined

from taking any adverse action relative to the awning based on the board's decisions currently before the court.

The decision deemed abandoned that portion of the complaint seeking a declaration that the awning was "an appurtenant structure to the building," inasmuch as neither side addressed that issue. The motion court granted the cooperative's summary judgment motion, in part, only to the extent of severing and dismissing the three later-added causes of action for abuse of process/harassment (for failure to state a claim), and prima facie tort (for failure to plead special damages) and defamation of reputation and credit (for failure to plead with the requisite specificity).

In its decision, the motion court held that the business judgment rule did not apply to the board's decision to give priority to the through-the-wall air conditioning house rule over the permissive use of the awning because the board had engaged in arbitrary decision-making that failed to take notice or consideration of the relevant facts. In a complete turnaround from its prior decisions denying as irrelevant discovery of the 12th-floor shareholder and the managing agent concerning the alteration, the court in its decision delved deeply into details of the cooperative's decision-making process in connection with the work and found the board wanting.

The court noted, among other things, that (1) the alteration plans submitted by the upstairs shareholder to DOB did not depict the through-the-wall installation and that the through-the-wall air conditioner work was never properly submitted to, nor approved by, DOB; (2) the cooperative's board never reviewed or approved the alteration plans in any manner, but rather merely submitted them to the managing agent and architect for review in violation of the cooperative's house manual that provided that alteration approval could only be made by the board; (3) the cooperative's architect had not reviewed plans depicting the proposed through-the-wall work; (4) the delegation by the board to the managing agent and architect violated the bylaw provision permitting the board to delegate only "ministerial acts," (5) the predicate notices were fatally defective because they erroneously referred to a house rule that had nothing to do with awnings and thus failed to identify any alleged breach; and (6) the cooperative's contention that the awning was installed without authorization was "in no way appropriate to the facts."<sup>1</sup>

## Unanimous Reversal

The Appellate Division's decision in *Horwitz*, a short, but sharply worded decision, unanimously reversed the motion, stating in relevant part: "We perceive no basis for Supreme Court's interference in the management prerogative of the cooperative's board of directors." The First Department held that independent of any need occasioned by the upstairs' shareholder's air conditioning installation, the cooperative's right to require removal of the awning was authorized under the current house rules, regardless of whether the original installation had been authorized or not. Given that the rule prohibiting awnings was generally applicable to the shareholders generally, there was no discriminatory purpose to the rule that overcame the presumption that the directors "exercised their honest judgment to promote the lawful and legitimate interests of the corporation (*Jones v. Surrey Coop. Apts.*, 263 A.D.2d 33, 36 [1999])."<sup>2</sup>

Citing to the recently decided case of *40 West 67th Street Corp. v. Pullman*, 100 N.Y.2d 147, 790 N.E.2d 1174, 760 N.Y.S.2d 745 (2003), the appellate court also stated that since the cooperative did not seek to terminate the lease of the plaintiffs, the court's review need not reach the level of "heightened vigilance" in examining whether the board's action meets the *Levandusky* test relating to the business judgment rule.<sup>3</sup> This portion of the decision alone might lead to a change in strategy in dealing with a shareholder whose actions are in violation of his proprietary lease. Perhaps, based upon the reasoning of the Appellate Division, it would be best for a cooperative to bring an action seeking equitable relief against such a tenant, rather than to bring an action to terminate the lease.

The *Horwitz* decision also casts a new light on the concept of "grandfathering." The awning in question had been installed for 50 years prior to the commencement of the case, and in fact was presumably permitted when the cooperative was first created. The fact that the cooperative permitted (or at least acquiesced to) the existence of the awning for decades did not seem to phase the Appellate Division. Further, the court gave full weight to the no-waiver clause of the lease and applied it to the situation at hand. The Appellate Division even noted that its holding would not have been any different had the awning been previously approved by the board.

Thus it seems that the Appellate Division has taken the position that board policies can change, and courts should not interfere with the board's decisions. This presumes of course that the *Levandusky* "business judgment rule" should apply. *Levandusky* held, in essence, that a cooperative board's decision would not be reviewed by the courts if the board acted for the purposes of the cooperative, within the scope of its authority, and in good faith. Further, as noted by the court, there is a strong presumption of good faith afforded to the board.

Another way of looking at *Horwitz* is to consider the fact that while most previous decisions involving the business judgment rule centered around the actual decision of the board, *Horwitz* applies the business judgment rule to the right of a board to make changes in long-standing policy. As noted above, the *Horwitz* decision applies *Levandusky* not only to a board's decision itself, but to the right of the board to change its policy.

Notwithstanding the good news for cooperatives in the *Horwitz* decision, cooperative boards must be cognizant of the fact that all decisions of the board are not immune from judicial review. Besides the three prong test of *Levandusky*, if the bylaws or lease provide that consent of the board is "not to be unreasonably withheld," the business judgment rule is inapplicable.<sup>4</sup>

1. Decision, Supreme Court, 6/19/03, p. 7.

2. *Id.*, 7 A.D.3d at 462, 777 N.Y.S.2d at 483.

3. *Levandusky v. One Fifth Ave. Apartment Corp.*, 75 N.Y.2d 530, 554 N.Y.S.2d 807, 553 L.Ed.2d 1317 (1990).

4. *Ludwig v. 25 Plaza Tenants Corp.*, 184 A.D.2d 623, 584 NYS2d 907 (App. Div. 1st Dept. 2004).