

# Tenant/Shareholders Battle Co-op Sponsors

## Voting Control, 'Unsold Share' Issues

BY ANDREW P. BRUCKER

**N**OT UNLIKE the prairie wars in the Old West between cattle ranchers and farmers, the war between co-op sponsors and the tenant/shareholders in their buildings has raged on for years. In both cases, the parties seek control of property.

Ranchers sought to use the land for cattle grazing, whereas the farmers found this to be destructive and preferred using the land for crops. In 20th century New York, the territorial wars take on a different look: Sponsors seek a greater return on their investment, while tenant/shareholders seek a better quality of life and control over the buildings in which they have made their homes.

Typically, sponsors will claim that their interest is identical to the concerns of the tenant/shareholders in the building. While this may be partially true, there exists a very real and overriding difference between the parties. Since profit is the primary concern of the sponsor, it may rent one of its apartments to a high rent-paying tenant who might not ordinarily be considered a desirable a neighbor.

Further, repairs or improvements (often aesthetic) which a co-op board feels are desirable may be considered a complete waste of corporate funds by the sponsor. This is especially true if the sponsor owns a large

portion of the building, for that sponsor would be responsible for paying the lion's share of any assessment. Thus, the interests of the sponsor (an absentee owner) and that of the tenant/shareholders are very often in conflict.

Perhaps the most significant battle between sponsors and the tenant/shareholders is the issue of who controls the corporation. Since the business of the co-op corporation is controlled by its board of directors, the issue of who has the right to elect the board is fundamental.

Most of the confusion in this area is derived from the fact that the Department of Law's regulations set forth a maximum time period beyond which a sponsor may not control the co-op board.<sup>1</sup> The regulations provide that the sponsor of a non-eviction plan (overwhelmingly the most common of co-op conversions) must agree that the sponsor and other holders of unsold shares shall not exercise voting control over the co-op board of directors for a period in excess of five years, but in no event after the unsold shares constitute less than 50 percent of the total number of shares in the co-op corporation.

Unfortunately, the phrase "voting control" is not defined, which has resulted in a decade of litigation as sponsors attempt to vote their shares, while other shareholders hope to keep the sponsors' influence over the board to a minimum. One such case, *Rego Park Gardens v. Rego Park Gardens Owners Inc.*<sup>2</sup>, involved a set of facts very common in New York City.

Under the terms of the offering plan and proprietary lease, as long as the sponsor owned unsold shares, it had the right to

designate a specified number of directors prior to the election of the board at the annual meeting. The plan also provided (as required by the Department of Law) that the sponsor would not exercise voting control over the board after it owned less than 50 percent of outstanding shares of the co-op corporation. At the election in question, the sponsor (now owning 35 percent of the shares) designated two of the five directors, but was informed by the co-op corporation that it could not vote at the election of the board.

The co-op corporation took the position that to allow the sponsor to vote for the remaining three directors would be an attempt to exercise voting control of the board, which was prohibited now that the sponsor owned less than 50 percent of the shares. The co-op argued that to allow the sponsor the right to vote a large block of votes would determine the outcome of the election, resulting in the type of "voting control" prohibited by the plan, the proprietary lease and the Department of Law's regulations. It should be noted that litigation against the sponsor was one of the topics to be considered by the newly elected board.

Although the lower court refused to grant summary judgment to either party, the Appellate Division, First Department reversed and granted the sponsor's motion for summary judgment. The panel held that the sponsor had every right to designate its two directors and to vote for the other three, saying that "the mere fact that new directors may be elected with the votes of the sponsor cannot, without more, be equated with exercising voting control as a matter of law." The court did state,

**Andrew P. Brucker** is a partner in Schechter & Brucker PC, a firm specializing in the representation of coops and condos.

however, that the sponsor could not vote for any candidates which were on its own slate of directors, or on its payroll or who received any remuneration from it.

Less than a year later, another case quite similar to *Rego Park Second Department*.<sup>3</sup> In that case, the sponsor sought to set aside an election of the board where it had been prohibited from voting for more than three of the seven directors. The Appellate Division affirmed the lower court's decision granting the sponsor's motion for a preliminary injunction barring the board, elected without the sponsor's participation, from taking certain action.

The panel agreed with the holding in *Rego Park*, stating that "the cooperative corporation cannot prevent the [sponsor] from voting for any director unless it is shown that the director in question is on the [sponsor's] own slate or receives a salary or other remuneration from it." The court also quoted comments from the Attorney General, stating that:

The position of the Department of Law with regard to what constitutes board control by the [sponsor] involves not disenfranchisement of the petitioner but rather its inability to designate related parties to fill a majority of the board member seats. Therefore, although the [sponsor] may vote its shares, it may not nominate or designate more than three of the seven board members if it is no longer in control.

### Importance of Language

IT seemed resolved by the case law, some co-op boards recognized that if the precise wording of their offering plans and proprietary leases deviated from those reviewed by the courts, that they might not be subject to the courts' rulings. In one such case,<sup>4</sup> an amendment to the plan provided that "Sponsor will vote its shares so that its votes and those of other holders of unsold shares will not elect a majority of the Board of Directors."

Unfortunately for the tenant/shareholders, the First Department held that that provision did not prohibit the sponsor from combining her votes with those of other resident shareholders who were not holders of unsold shares. Citing *Rego Park*, the panel held that to hold otherwise would deprive the sponsor of her right to vote all of her shares, a result that could only be accomplished through a provision in the certificate of incorporation.

However, in two other cases the tenant/shareholders triumphed over the sponsors due to wording in the documents. In *Flagg Court Realty Co. v. Flagg Court Owners Corp.*,<sup>5</sup> the offering plan stated that the sponsor "will not elect a majority of the Board, even though the number of shares owned by them would enable them to do so." The plan went on to state that "Sponsor or its designee shall have the right to elect three of the seven directors." The Second Department, emphasizing the word "elect," held that *Park Briar* did not apply and that the sponsor had no right to vote for more than three of the seven directors.

With a similar set of facts, the co-op in *Frost Equities Co. V. Frost Owners Corp.*<sup>6</sup> was able to limit the sponsor's right to vote. The by-laws in *Frost* provided that "the holders of Unsold Shares may not elect a majority of Board of Directors for more than five years after the closing date ... The holders of Unsold Shares shall have the right to designate one (1) Directors so long as they hold at least twenty five (25%) percent of the outstanding shares."

The First Department did not disenfranchise the sponsor, but held that at the election of the co-op's seven-member board, the sponsor's votes would be counted only until the three candidates receiving the most votes (including the sponsor's) were determined, and thereafter, the votes of the sponsor would be ignored. The result was that the majority of the board would consist of candidates favored by tenant/shareholders.

It thus becomes clear that the precise language of the by-laws, the proprietary leases and the offering plans is the determining factor in whether a sponsor can freely vote for candidates to the board. As a result, there will undoubtedly be many more such cases, as tenant/shareholders carefully review their co-op documents in order to protect their right to control their homes.

### Holding Unsold Shares

The second major battle between sponsors and tenant/shareholders deals with the very issue of who is a holder of unsold shares. Every cooperative proprietary lease provides that holders of "unsold shares" enjoy certain special and valuable rights. Typically, a holder of unsold shares may sell or sublease its co-op unit without the board's approval, and need not pay any subleasing fee or "flip tax" (an assessment

paid to the co-op by the seller of a co-op unit). Such approvals and fees are typically required of ordinary shareholders.

The proprietary lease and offering plan usually define unsold shares as those shares issued at the closing to the sponsor or individuals produced by the sponsor. When the sponsor (or person designated at the original closing to receive such shares) sells a unit in a co-op to an investor, the purchaser very much desires to inherit such special rights and thus seeks to be classified as a holder of unsold shares. The controversy centers around a paragraph typically found in co-op proprietary leases (often designated as paragraph 38(a)):

"Unsold Shares" retain their character as such (regardless of transfer) until (1) such shares become the property of a purchaser for bona fide occupancy (by himself or a member of his family) of the apartment to which such shares are allocated, or (2) the holder of such shares (or a member of his family) becomes a bona fide occupant ...

For many years, it was assumed that any investor who purchased an occupied co-op unit from a sponsor would be considered a holder of unsold shares, as long as the investor never intended to move into the unit, and in fact neither the investor nor a relative ever did. Even if the unit was bought and sold many times by various investors (none of whom ever intended on moving into the unit), it was assumed by many that each subsequent owner of the unit should be considered a holder of unsold shares. Though there was doubt that this was true, and boards were informed by their counsel that this might be incorrect, many boards felt that the cost of litigating the issue would not be cost effective.

The inequity of allowing subsequent purchasers of unsold shares to have special privileges is obvious. A purchaser of a co-op for occupancy discovers that a large number of the units are not owned by tenant/shareholders, but by a sponsor. However, knowing the financial background of the sponsor, the purchaser believes that this will not impact on the financial stability of the co-op. But what happens when the sponsor, needing to liquidate, sells to an investor who creates a shell corporation to buy the unsold shares? Who protects the tenant/shareholders in this case?

With this as a background, the Attorney General issued regulations regarding unsold shares which define such shares.<sup>7</sup> Then, a number of years later, in response to

a court inquiring as to meaning of the regulations, the Attorney General's office issued a memorandum dated Oct. 6, 1987, entitled "Definition of Holder of Unsold Shares," seeking to clarify once and for all the question of when an assignee/transferee inherits the rights of the holder of unsold shares from whom the units in question are purchased.

The memorandum stated that the owner of unsold shares is not necessarily a "holder of unsold shares." To obtain the status as a "holder of unsold shares" the shareholder must

- (i) obtain a "designation" as a "holder of unsold shares" from the sponsor upon its purchase of the shares,
- (ii) obtain a written guarantee of all of its financial obligations from the sponsor,
- (iii) comply with the escrow and trust fund provisions of the Business Corporation Law,
- (iv) register as a broker-dealer with the Department of State, and
- (v) file regular update amendments of the offering plan.

In addition, the memorandum made it clear that on each subsequent transfer of unsold shares, the sponsor must designate each transferee, and that the sponsor may only designate financially responsible parties as "holders of unsold shares." The memorandum reasoned that "bearing the burdens associated with being a holder of unsold shares is the quid pro quo for the benefits obtained from such status."

At first, it was not clear that the courts would give weight to the Attorney General's regulations or memorandum. There is some sentiment in the New York legal community that the Attorney General's office has no legislative authority, and that it has at times gone beyond its authority.

After all, in 1960, when the New York State Legislature sought to protect purchasers of co-ops and condos, it did so not by creating a new law with substantive requirements, but by adding provisions to the Martin Act, New York's "Blue Sky" law, which requires full disclosure on the sales of securities. Clearly, the Legislature believed that the purchasers of co-ops and condos would be protected by their own analysis of all of the risks, and the Department of Law was given authority to impose disclosure obligations.

In fact, the Court of Appeals has held that the Martin Act does not give the Department of Law free reign to create requirements. In striking down

a regulation which required sponsors to eliminate hazardous conditions in their buildings, the court stated that "Section 352-e is not, in any sense, an omnibus enforcement statute ... it is a disclosure statute, designed to protect the public from fraudulent exploitation in the sale of real estate securities."<sup>8</sup>

Thus, it is understandable that the Attorney General's memorandum concerning unsold shares was looked upon with some skepticism. Even after its release, many boards felt compelled to negotiate a settlement with an investor claiming to be a holder of unsold shares, rather than litigate the issue.

In the early decisions following the release of the memorandum (i.e., those heard in the late 1980s), courts were not yet ready to embrace the Attorney General's point of view.<sup>9</sup> But soon thereafter, they began to dissect the infamous paragraph 38(a), which had been used by every owner of an occupied unit to claim the status of a holder of unsold shares.

In *Craig v. Riverview East Owners Inc.*,<sup>10</sup> the First Department held that the language of paragraph 38(a) "does not create rights, it merely extinguishes them." While the panel was asked only to review the IAS court's refusal to grant summary judgment, the effect was very real: If an owner of unsold shares could not depend on paragraph 38(a), how could he or she claim to be a "holder of unsold shares"?

A decade later, in *Thomson v. 490 West End Apartments Corp.*,<sup>11</sup> the First Department relied on the Attorney General's regulations as determinative of the issue of whether an owner of unsold shares was a "holder of unsold shares." That panel held that the regulations were clear, and that

A holder of unsold shares is the sponsor or any individual designated to hold unsold shares by the sponsor. Such shares shall cease to be unsold shares when purchased by a purchaser for occupancy ... [Further, in order for the assignee to be deemed a holder of unsold shares] the sponsor must guarantee the payment of all maintenance charges and assessments due from a holder of unsold shares, and must represent that it has financial resources to meet this obligation.

Recently, in *Gorbatov v. Gardens 75th Street Owners Corp.*,<sup>12</sup> the Second Department provided what amounts to a checklist of facts which must exist before the owner of a unit (or units) can be considered

a holder of unsold shares. The court held that the sponsor must designate the assignee as a holder of unsold shares, and that the assignee must amend the plan to provide current and accurate information (just as is required of the sponsor), must comply with the trust and escrow provisions of the law, and must register as a broker-dealer. And, of course, as noted in Thomson, it be financially responsible.<sup>13</sup>

While there is a better understanding of the issues of sponsor voting rights and the definition of "holder of unsold shares," the battles between sponsors and tenant/shareholders continue to wage on. So long as sponsors and holders of unsold shares are not required to sell their co-op units, antagonism will continue.

From the problem of refinancing a co-op's underlying mortgage due to too many non-occupying shareholders, to the financial problems befalling a co-op in which a sponsor owns a large portion of units but is constantly months late in paying its maintenance, co-ops will be faced with continual problems. The only real solution is for the Legislature to take a careful look at the co-ops, and once and for all take a stand on these, and many other, issues.



1. 13 N.Y.C.R.R. Part 18.3(v)(5).
2. 570 N.Y.S. 2d 550 (1st Dept., 1991).
3. *Park Briar Associates v. Park Briar Owners Inc.* 582 N.Y.S.2d 273 (2d Dept., 1992).
4. *Alan Madison v. Theodore Striggles*, 644 N.Y.S.2d 6 (1st Dept, 1996).
5. 646 N.Y.S.2d 298 (2d Dept., 1996).
6. 637 N.Y.S.2d 929 (1st Dept., 1996)
7. 13 NYCRR Part 18.3(w).
8. *Council for Owners Occupied Housing Inc. v. Abrams*, 534 N.Y.S.2d 906 (Ct. of App., 1988).
9. *Riggin v. Balfour Owners Corp.*, 525 N.Y.S.2d 347 (2d Dept., 1988).
10. 548 N.Y.S.2d 204 (1st Dept., 1989).
11. 676 N.Y.S.2d 73 (1st Dept., 1998).
12. 668 N.Y.S. 2d 691 (2d Dept., 1998). See, also, *Lee v. Glen Oaks Village Owners Inc.*, *New York Law Journal* QDS No. 72503911.
13. See, also, *Multiboro Realty Corp. v. Cabrini Owners Corp.*, *N.Y.L.J.*, June 5, 1996, p. 25, col. 6 (Sup. Ct., N.Y. Co.).

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