

New York Law Journal



Web address: <http://www.law.com/ny>

VOLUME 228—NO. 44

WEDNESDAY, SEPTEMBER 4, 2002

COOPERATIVES AND CONDOMINIUMS

BY RICHARD SIEGLER AND EVA TALEL

'Levandusky' Update: Slim Odds on Reversing Board Decisions

IN THE 1990 seminal Court of Appeals decision, *Levandusky v. One Fifth Avenue*,¹ Chief Judge Judith S. Kaye found that maintaining the stability of the common living arrangement that typifies co-ops and condominium associations requires that co-op and condominium board decisions be protected by the business judgment rule — which prohibits judicial inquiry into actions of corporate directors taken in good faith and in the lawful and legitimate furtherance of corporate purposes. Absent a showing of bad faith, discriminatory conduct or illegality, an owner who is simply dissatisfied with a particular board action cannot obtain judicial review.

Courts continue to apply this reasoning to determine challenges to board decisions. This column examines 14 appellate cases decided since March 1998, when a previous column appeared,² dealing with the application of *Levandusky* to challenged board determinations. These cases demonstrate continued adherence to the *Levandusky* principle of judicial deference to discretionary board decisions. However, where board action contravenes a co-op or condominium's contractual obligation, courts have uniformly rejected use of the



Richard Siegler

Eva Talel

business judgment rule to shield such board action from judicial scrutiny.

Eviction for Objectionable Conduct

No discussion of recent case law under *Levandusky* would be complete without addressing the May 2002 decision of the First Department in *40 West 67th Street v. Pullman*.³ In a 3-2 ruling, the court summarily held that a co-op board's determination to evict a shareholder for objectionable behavior — based on an overwhelming vote of the co-op's shareholders under a proprietary lease provision permitting such evictions — is insulated from judicial review by *Levandusky*. The *Pullman* majority held that the business judgment rule is the standard of review to be applied to all co-op board determinations. The majority noted that a shareholder sought to be evicted was not without remedy if the shareholder could show that the board action was illegal, discriminatory or in bad faith — the touchstone elements that remove a determination from the protection of *Levandusky*.

The *Pullman* minority argued that *Levandusky* was inapplicable because eviction proceedings for objectionable

conduct are governed by Real Property Actions and Proceedings Law §711, which requires a judicial hearing — not a shareholder vote — to establish objectionable conduct sufficient to sustain an eviction. The minority urged that *Levandusky* should be construed narrowly, to apply only to day-to-day business or financial decisions.

Pullman has been appealed to the Court of Appeals and will likely be heard in the fall of 2002. The Court of Appeals' decision will provide important guidance as to the applicable scope of *Levandusky*. In the interim, a number of intermediate appellate courts have addressed the scope of the *Levandusky* doctrine.

Managerial Prerogative

In *Schultz v. 400 Co-op Corp.*,⁴ the First Department applied *Levandusky* but rejected the shareholders' disparate treatment claim for an over-allocation of co-op shares to their apartment because there was no demonstrable injury — there was no significant discrepancy between the challenged allocation and shares allocated to comparable apartments.

In this case, the shareholders purchased 250 shares allocated to a ground-floor unit for professional office use. The shareholders were initially required to pay a \$300-per-month "professional fee," which was subsequently eliminated and 75 additional shares were allocated to the unit in lieu of this fee. Thereafter, the shareholders desired to discontinue professional use and sought a reduced share allocation; the board refused. The shareholders sued and sought to avoid the business

Richard Siegler is a partner in the firm of *Stroock & Stroock & Lavan* and is an adjunct professor at New York Law School where he teaches a course on cooperative housing and condominium law. **Eva Talel** is also a partner in *Stroock & Stroock & Lavan*, specializing in litigation involving co-ops and condominiums.

Kimberly Sparagna, a student at New York Law School, assisted in the preparation of this article.

judgment rule by alleging unequal treatment between them and another unit owner, a former president of the co-op board, to whose unit only 220 shares were allocated. The IAS Court summarily awarded plaintiffs judgment, declaring the proper share allocation to be 200 shares. The First Department reversed, holding that because the shareholders demonstrated no injury, the application of the business judgment rule insulated the board's discretionary exercise of management prerogative.

In *Hidden Ridge at Kutsher's Country Club Homeowner's Ass'n, Inc. v. Chasin*,⁵ the Third Department found that the business judgment rule protected a determination by the board of a homeowners association because it was within the scope of its authority — to administer and enforce restrictions on the use of “common land.” The homeowner sought permission to build a 12-foot by 16-foot wooden deck; the board only approved a 10-foot by 12-foot removable wooden deck. The homeowner, nonetheless, built a concrete block patio measuring 10-feet by 20-feet. The Third Department, finding no evidence that the board acted in bad faith or beyond its authority, invoked *Levandusky* and held that the propriety of the board's decisions was not subject to judicial review.

Similarly, in *Vink v. N.Y. State Div. of Hous. & Cmty. Renewal*,⁶ the First Department shielded the board's actions under the business judgment rule. This case involved New York's Private Housing Finance Law, which established partially subsidized co-op apartments to promote rehabilitation and attract middle-income city dwellers. Higher-income residents were not excluded; however, tenants with incomes above agency guidelines were to be surcharged up to 50 percent above normal rent. The board imposed a surcharge of 20 percent. The lower-income tenants sought to compel the board to raise the surcharge to the statutory 50 percent maximum, while the higher-income tenants challenged the 20 percent increase. The First Department sustained the 20 percent surcharge and held that the failure to impose a 50 percent surcharge was not arbitrary or capricious. The statute gave co-op boards responsibility

for determining surcharges; so long as the board complied with the statute, its business judgment in making such determinations would not be questioned.

Additionally, in *Jacobs v. 200 E. 36th Owners Corp.*,⁷ the First Department held that a board's prohibiting food delivery by placing packages on the elevator floor and sending it, unattended, up to the appropriate resident was not subject to judicial review. The board required that food deliveries be picked up in the lobby of the building. The court found no evidence that this rule was not made to further the legitimate concerns of safety and cleanliness; therefore, the business judgment rule governed and the court would not intervene.

Finally, in *Kleinman v. Point Seal Restoration Corp.*,⁸ the Second Department held that a board's retention of contractors is governed by the business judgment rule. The board acted within the scope of its authority under the bylaws and in good faith selected a contractor; no evidence to the contrary was submitted. The court held that the board's selection was not reviewable.

Bad Faith

In *Jones v. Surrey Coop. Apts. Inc.*,⁹ the First Department rejected a shareholder's challenge to a board determination allegedly based on “bad faith.” There, an evicted shareholder sought to recover from the co-op the market value of the shares allocated to the apartment. Under the co-op bylaws, upon termination of a tenancy, the co-op had the option of repurchasing those shares at book value, which it did. The shareholder alleged that the option allowed the co-op to be arbitrary in determining whether a shareholder would be paid market or book value. The court held that without a showing of a breach of a specific fiduciary duty to these shareholders — which had not been made — the business judgment rule precluded court intervention.

Similarly, in *Cooper v. 6 West 20th St. Tenants Corp.*,¹⁰ the First Department rejected a bad faith claim. There, plaintiffs' shares were purchased in a foreclosure sale by a co-op director.

Plaintiffs sued the co-op, alleging that it impeded plaintiffs' efforts to sell their shares in order to enable a board member to purchase them at a below-market price. The court held that the co-op's actions were protected by the business judgment rule because there was no evidence — after substantial discovery — that the board acted in “bad faith.”

House Rules

Generally, the actions of a co-op or condominium board in enacting, repealing, and enforcing house rules will be protected from challenge.¹¹ However, if the aggrieved owner can demonstrate that such actions were improper, the courts will not hesitate to review them.

In *Vacca v. Board of Managers of Primrose Lane Condo.*,¹² the Second Department refused to allow a board's conduct to be shielded from judicial review. There, owners of single-family units in a condominium development placed religious statues outside of their units. These statues remained undisturbed for more than six years until the condominium board notified the unit owners that, pursuant to a new regulation, all religious statues must be removed. When this regulation was challenged, the board repealed it, and then asserted that the statutes violated an existing house rule, which provided that the common elements were not to be obstructed.

The court acknowledged *Levandusky*, but found that the board acted in bad faith. The board had allowed the statues for six years and had not construed the house rule to prohibit them. By enacting (and repealing) a regulation and then construing the existing house rule to achieve the same result, the court held that the board acted in bad faith and its decision was not protected by the business judgment rule.

In contrast, in *W.O.R.C. Realty Corp. v. Carr*,¹³ the Second Department upheld a board's right to enforce house rules and regulations. There, the board of plaintiff recreation club terminated defendants' membership for failing to comply with its winter occupancy rules and regulations. The court summarily held that defendants failed to support

their allegations of disparate treatment or selective enforcement. The board's decision was therefore protected by the business judgment rule, having been made in good faith and within the scope of the board's authority.

Finally, in *Sirianni v. Rafaloff*,¹⁴ the Second Department held that, notwithstanding allegations of racial discrimination, the board's termination of a proprietary lease was protected by the business judgment rule. There, the shareholders sued the board for wrongful termination, alleging that it was motivated by racial discrimination. The board demonstrated that the basis for the termination was the shareholders' failure to discontinue their business use of the premises, notwithstanding the service of two notices to cure. Invoking *Levandusky*, the court unanimously dismissed the claims.¹⁵

Breach of Contract

The one area where courts have made clear that the *Levandusky* doctrine has no place is where board action breaches a contractual obligation of the co-op or condominium. Simply put, the business judgment rule will not insulate a board from liability for breach of a contract.

In *Dinicu v. Groff Studios Corp.*,¹⁶ plaintiff purchased a co-op for use as a residence and dance studio. The offering plan stated that the co-op would seek a zoning variance to permit such use. Initially, the Board of Standards and Appeals denied the variance. Thereafter, the Zoning Resolution was amended and provided for amnesty for existing dwelling units provided that an application to permit such use was filed with the Department of Buildings. The co-op's amnesty application was granted, but it incorrectly listed plaintiff's use as exclusively residential, as did the new certificate of occupancy.

A couple subsequently moved into the unit above plaintiff's, which was still being used as a dance studio. The couple objected to the noise and complained to the board that the mixed use was illegal; they also complained to the Department of Buildings, which issued a notice of

violation. Documentation was prepared by the co-op's architect to amend the certificate of occupancy to show a lawful mixed use. However, it required the co-op's signature. The co-op board did not execute the document. Instead, it referred the matter to the shareholders, who twice voted to deny approval. Plaintiff thereupon obtained space in another building (at a substantial cost) and sustained losses for several years in subletting her unit, finally selling it at a loss. Plaintiff sued the co-op for these financial losses.

The IAS court found that the business judgment rule did not protect the board from liability because the failure to execute the documentation legalizing plaintiff's mixed use, as specifically contemplated by the offering plan, breached a contract. The court allowed the claim to proceed and also remanded the case to determine damages and plaintiff's legal fees, as the prevailing litigant under Real Property Law §234.

Similarly, in *Whalen v. 50 Sutton Place S. Owners, Inc.*,¹⁷ the First Department did not defer to a co-op board's decision on a breach-of-contract claim. There, a co-op board approved plaintiffs' plans to renovate their apartment, including an increase to the apartment's electrical supply, and provided plaintiffs with an alteration agreement and authorized them to commence work. However, on the same day, the co-op verbally revoked its approval, because it desired to preserve the building's electrical reserves. Plaintiffs abandoned the renovation, sold the apartment in a demolished state, and sued the co-op for breach of contract and damages, including their expenses in the aborted renovation and their loss on the re-sale. The court rejected the co-op's claim that the decision to rescind approval was a valid exercise of discretion protected by the business judgment rule.

However, in *Sherry Assoc. v. Sherry-Netherland, Inc.*,¹⁸ the First Department held that the mere characterization of a claim as one for "breach of contract" does not defeat the operation of the business judgment rule. There, plaintiffs owned transient units in a co-op and

challenged, as a breach of contract, the manner in which the board was managing the co-op's transient operations. The court summarily found that plaintiffs did not demonstrate the breach of any specific obligation, but challenged only the manner in which the co-op operated the transient operation, as to which the proprietary lease afforded the board "discretion." Because judicial review of discretionary co-op management determinations is precluded, the court summarily dismissed plaintiffs' "breach of contract" claims.

Conclusion

Despite the passage of time and emergence of new challenges to board action, the *Levandusky* standard prevails: the odds of reversing a discretionary board decision are slight. However, where board actions are not discretionary and breach a co-op's or condominium's contractual undertakings, courts do not hesitate to apply settled contract law principles and assess damages, including statutorily mandated attorneys fees to the prevailing party.

(1) 75 N.Y.2d 530 (1990).

(2) See Siegler, "Levandusky Revisited," *The New York Law Journal*, March 4, 1998, at 3, col. 1.

(3) 742 N.Y.S.2d 264 (1st Dept. 2002).

(4) 292 A.D.2d 16 (1st Dept. 2002).

(5) 289 A.D.2d 652 (3rd Dept. 2001).

(6) 285 A.D.2d 203 (1st Dept. 2001).

(7) 281 A.D.2d 281 (1st Dept. 2001).

(8) 267 A.D.2d 430 (2d Dept. 1999).

(9) 263 A.D.2d 33 (1st Dept. 1999).

(10) 258 A.D.2d 362 (1st Dept. 1999).

(11) See Siegler, "House Rules: The Impact of *Levandusky*," *NYLJ*, March 6, 1991, at 3, col. 1.

(12) 251 A.D.2d 674 (2d Dept. 1998).

(13) 262 A.D.2d 310 (2d Dept. 1999).

(14) 284 A.D.2d 447 (2d Dept. 2001).

(15) See also, *Rahman v. Bd. of Mgrs. of Yardam Condo*, Index No. 96-6390 (Sup. Ct. Suffolk Co., May 7, 2002), where the court relied on *Levandusky* and refused to inquire into the wisdom or soundness of a condominium board's decision to purchase full replacement cost insurance (as required by the bylaws) which did not include coverage for additional costs required to comply with updated building codes. As a result, the condominium unit owners were assessed \$4.3 million to rebuild in compliance with updated building codes after a fire destroyed a substantial portion of the complex. Nonetheless, the court held that the actions of the board in placing insurance coverage that later proved to be inadequate cannot be challenged. A notice of appeal has been filed.

(16) 257 A.D.2d 218 (1st Dept. 1999).

(17) 276 A.D.2d 356 (1st Dept. 2000).

(18) 273 A.D.2d 14 (1st Dept. 2000).