Co-Op Apartment Transfers: Rejecting an Applicant

IN RESPONSE to certain well-publicized cases in recent years regarding individual liability for board members of cooperative housing corporations, co-op boards have had to rethink their procedures for apartment transfers. A particular focus is the review process for prospective apartment purchasers amid concerns that boards comply with an array of federal, state and city laws that have been in place for many years to prohibit discriminatory housing practices.

A 1997 case involving racial discrimination in violation of both federal and state laws relating to a sublease disapproval resulted in a jury award of $230,000 in compensatory damages and $410,000 in punitive damages, $125,000 of which was assessed individually against a board member. Further, in a subsequent case brought by such board member, it was held that the individual board member was not entitled to indemnification for punitive damages under the co-op's bylaws. Thus, service on a co-op board is not without exposure to substantial personal liability.

This column recommends steps to be followed by co-op boards when confronted with apartment transfer applications and specifically a decision to reject an applicant. The advice should be useful for attorneys representing both co-op boards and individual board members.

Purchase Application

The starting point for any transfer is to require a comprehensive, completed purchase application. The Real Estate Board of New York has printed a standardized purchase application for use by management firms. This is a good starting point to elicit basic information about a prospective purchaser. The application should be accompanied by a copy of the purchase and sale agreement, copies of IRS form 1040 with schedules for two years, a financial statement of assets, liabilities and net worth on a form approved by the co-op board, three personal financial letters, two financial reference letters, two business reference letters and, if applicable, a loan application commitment and recognition agreement. Incomplete applications should not be considered.

Financial Investigation

The tax return and financial statement should be scrutinized especially by board members with a financial background. Ideally, board members who are accountants, bankers or financial advisers should be asked to make a recommendation to board members on the financial suitability of the applicant. It has long been established law, both in New York and elsewhere, that the ability of a co-op shareholder to pay his proportionate share of the co-op's expenses is of paramount concern. Some co-ops may wish to establish informal guidelines and qualifying ratios to establish that purchasers meet certain minimal financial criteria.

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tool, the criteria should be applied in a fairly uniform fashion with appropriate exceptions. For example, a young couple that might be light on net worth may be able to compensate for this based upon a satisfactory level of current income.

Criteria to be considered by the board might include the following financial ratios:

(a) recurring income to anticipated housing expenses;
(b) recurring income to anticipated annual obligations;
(c) liquid assets to annual obligations; and
(d) net worth to purchase price.

The ratios to be used above will vary from building to building and over time. In some instances, not all qualifying ratios need to be met. Any deficiency in a qualifying ratio may be overcome by requiring a guaranty from a qualified individual, usually a close relative, or by an escrow deposit equal to one or two years' maintenance. If the application raises questions about financial ability, it would not be inappropriate to seek further information from the applicant before making a decision.

Social Issues

New York case law provides that the directors of a co-op housing corporation have an absolute right for any reason, or no reason, absent prohibited discrimination, to restrain the transfer of co-op apartments. In some instances, not all qualifying ratios need to be met. Any deficiency in a qualifying ratio may be overcome by requiring a guaranty from a qualified individual, usually a close relative, or by an escrow deposit equal to one or two years' maintenance. If the application raises questions about financial ability, it would not be inappropriate to seek further information from the applicant before making a decision.

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idate the applicant. The key question is whether to grant an interview to a purchaser who does not appear to possess the financial requisites or social standing that is likely to be acceptable to the board. Obviously, the board should follow consistent policies in this regard.

However, it is the writer's recommendation that an interview not be granted if the board has any indication that it is unlikely to approve the prospective purchaser. By not granting an interview in such case, the potential for an allegation of discrimination to be made by a rejected purchaser is substantially diminished. Of course, such a procedure runs the risk that a desirable purchaser may be rejected because of the board's failure to inquire in greater detail. In the writer's view, the risk of a discrimination claim resulting from the interview of a rejected purchaser far outweighs the loss of a purchaser who might, after an interview, appear to be acceptable to the board. Thus, in most cases the granting of an interview should be used to confirm the board's initial reaction that the purchaser is acceptable subject only to a face-to-face meeting.

**Reasons for Rejection**

Members of co-op boards in New York must square the broad discretion they are given in approving or disapproving co-op apartment transfers under case law with both constitutional and statutory discrimination prohibitions. Confronted with this dilemma and particularly when considering an application involving protected classes, if a co-op board decides to reject a purchaser, it becomes incumbent upon the co-op, through either its managing agent or counsel, to memorialize its valid reasons for rejection. This should be done contemporaneously with the making of the decision to reject in order to refute a subsequent claim by the rejected applicant or the seller of the apartment that the rejection was based upon some prohibited discriminatory ground. Reasons that should justify rejection of a purchaser might include any of the following, all of which should be spelled out in confidence with some specificity depending upon the particular facts involved:

(a) Insufficient income or income history to meet rental and purchase money obligations.
(b) Insufficient or non-liquid assets so that rental and purchase money obligations may not be met.
(c) Assets held outside of the United States and not subject to judicial process, particularly if located in countries with unstable political regimes.
(d) An unfavorable credit report indicating a tendency for late payments or defaults.
(e) A history of involvement in certain types of litigation.
(f) Involvement in bankruptcy or other insolvency proceedings.
(g) False, misleading, vague, unresponsive or inconsistent statements contained in the purchase application, financial statement, tax return or personal interview which cast doubt upon the truth and veracity of the purchaser.
(h) Impression from the interview of the purchaser that the applicant is unlikely to abide by the policies, procedures and house rules of the co-op, especially with respect to pets, subleasing, noise, nuisance or alterations.
(i) Other indications that the applicant will display undesirable social behavior if approved or would adversely impact the reputation of the co-op as a result of occupancy by that person.
(j) The likelihood of excessive traffic in the co-op as a result of the applicant's occupancy.
(k) Risks to the security of the co-op or its occupants because of the fame or notoriety of the applicant.
(l) Excessive burdens which may be placed upon the co-op and its occupants because of security measures required for the applicant; for example, if the individual is a present or former governmental official.
(m) The possibility that the applicant might assert diplomatic immunity.
(n) The apartment is inadequate in size for applicant's needs; for example, a studio or one bedroom apartment will be inadequate for a couple with one or more children.
(o) The applicant intends to acquire the apartment for investment or speculative purposes and does not intend to occupy it as a primary residence.

**Professional Advisers**

In considering a purchase application which does not appear routine, it is advisable to consult with professional advisors who are familiar with co-op housing matters. Logical sources include the managing agent, co-op counsel and auditors. The managing agent may be able to obtain information about the applicant's personal standing as a tenant or shareholder in the shareholder's present residence. Counsel may be consulted to review the application and to note the existence of protected classes of individuals who could raise discrimination claims. The co-op auditor could be used to assist in determining the value of closely held businesses for which there is no public market. To the extent that the co-op incurs any expense from consulting with outside professionals, it can frequently pass on these expenses to the applicant if the applicant agrees in advance to assume responsibility for such expenses as part of the application process.

**Recording the Rejection**

If a co-op board determines to reject an apartment purchaser, it is recommended that the co-op's counsel be notified so that a contemporaneous record may be made (in a privileged context) indicating the reason for the board's rejection. This is important
because, if a discrimination claim is later made by the rejected applicant, the burden of proof to overcome such claim will fall on the co-op. The contemporaneous record of the basis for the rejection should help to meet this burden. A memorandum should be retained in the files of the co-op’s counsel. Of course, no reason for the rejection should be specified or entered into the corporate records. Notification of the rejection is best made verbally through the transfer department of the co-op’s managing agent without the involvement of any board member. In some instances, a letter may have to be written so that the seller and purchaser of the apartment in question will have a formal record to permit a termination of the contract of sale. This should be memorialized in a letter from the co-op’s managing agent addressed to both the seller and the purchaser saying no more than that the co-op board has disapproved the purchase application. Of course, before any such communication is sent, the managing agent should receive appropriate verbal instructions from the board member with responsibility for apartment transfers. The managing agent should make certain that there is some record of board action to reject, such as a notation in the particular apartment transfer file or a written memorandum stating only the action taken, usually by a majority of board members.

Post Rejection

Board members should be advised that both verbal and written communications regarding a rejection must be avoided in all events. Often, there will be strong pressure from an existing shareholder whose purchaser has been rejected to seek a reason for the rejection. There also may be “arm twisting” based upon personal relationships between the selling shareholder and board members. These efforts must be resisted at all costs because they destroy the confidential deliberations of board members and the ability of board members to properly perform their fiduciary responsibilities to all shareholders. Despite prior warnings, board members on occasion volunteer comments that undermine the board procedures. Such leaks suggest that board members who violate guidelines are not suitable board members. A breach of a confidential board decision may not only enhance a discrimination claim, but also may put in issue conflicts of interest and corporate opportunities by individual board members. For example, a board member who rejects a purchaser for his own self interest may expose not only himself, but also the co-op to claims for tortious interference with a contractual relationship between the seller and the purchaser.

If the managing agent or co-op board receives a claim that a purchaser was improperly rejected, such claims should be immediately reported to the co-op counsel for response. In such event, board members must avoid making any comments on the claim unless otherwise advised by counsel. If the claim results in a filing with a governmental agency alleging discrimination or litigation ensues, counsel must be sought. In some instances, the D&O (directors and officers) liability insurance policy maintained by the co-op will afford a defense of an action for both the co-op and individual board members. In some instances, where board members may have differing positions on the rejection, it would be appropriate for individual board members to consult with counsel to insure that their individual interests are protected.

Conclusion

The foregoing suggests that it is not all “fun and games” to be a co-op board member. Board service requires the member to act responsibly. Liability for acting in contravention of applicable law, especially when dealing with apartment purchasers, can be substantial. Obviously, qualified board members are vital to the continued success of co-op housing. However, individuals who are not prepared to take board responsibility seriously would be well advised not to serve.