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COOPERATIVES AND CONDOMINIUMS

Expert Analysis

Price as a Basis for Disapproval Of Apartment Sales

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Cooperative housing boards have a legitimate interest in maintaining the value of co-op apartments. This has led some boards to adopt a minimum transfer price— a floor price—below which transfers will be disapproved. However, a floor price can cause conflicts between board goals and those of selling shareholders.

A board may impose a floor price for several reasons. First, a board owes a fiduciary duty to its shareholders. To discharge that duty, a board will typically attempt to keep the value of apartment shares high; a floor price can help meet this goal. For example, if a one-bedroom apartment is sold at a below-market price, it is likely to negatively impact the value of other one-bedroom apartments in that building. However, if a floor price is imposed, the first apartment could not be sold below the floor price and the price of the next sale would not be negatively impacted. Further, a board may want to keep share prices high in order to collect higher transfer fees or flip taxes when the owner transfers the shares. These fees, if used to maintain the building's facilities and reduce maintenance charges, should increase the value of apartments.

However, the board's goals may be adverse to those of a selling shareholder who wishes to sell an apartment at a lower price. First, if the shareholder has purchased a new place to live, the shareholder may be willing to sell an apartment at a discount to avoid tax or mortgage payments on multiple properties. A shareholder may also simply need money and be unwilling or unable to wait for a down real estate market to improve or a purchaser who will pay floor price.

Is a floor price on co-op shares imposed by a board a valid reason for disapproving a transfer or will it be deemed an unreasonable restraint on alienation?

Is a floor price on co-op shares imposed by a board a valid reason for disapproving a transfer or will it be deemed an unreasonable restraint on alienation? This column discusses the competing interests and legal implications of imposing floor prices and suggests that coop boards refrain from doing so. We also propose alternatives that may help boards keep apartment prices high.

Directors' Fiduciary Duties

As a general rule, co-op boards owe a fiduciary duty to their shareholders. In *Matter of Levandusky v. One Fifth Avenue Apartment Corporation,*[1] the court defined this duty as one of loyalty, acting for the benefit of shareholders and for the purpose of the co-op, within the scope of the board's authority and in good faith.

So long as a board fulfills its fiduciary duty, courts will not review or second-guess board decisions, as mandated by the business judgment rule. Although the business judgment rule was established for review of board action by commercial corporations, New York courts have adopted it as the standard for review of co-op and condominium board actions.[2] Courts will overturn a board's action only if it is: (1) beyond the board's authority, (2) discriminatory, or (3) made in bad faith.

Restraints on Alienation

The alienability of corporate shares may be reasonably restrained. Thus, a co-op may restrict the transfer of its shares to preserve the unique nature of the co-op community because the restriction serves a legitimate corporate purpose.[3] So long as disapproval of an apartment transfer is not based on prohibited discrimination, board decisions will typically be upheld. As the Court of Appeals has consistently held, a co-op board has the right, absent prohibited discrimination, to disapprove of any potential apartment purchaser, with or without reason.[4] In addition, flip taxes which impose a fee paid to the co-op upon

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the transfer of shares, have been held to be reasonable restraints on alienation.[5]

However, a board may not unreasonably restrain a sale of shares. In *Chemical Bank v. 635 Park Avenue Corp.,*[6] the court enjoined a co-op from amending its proprietary lease to require shareholders involved in litigation with the co-op to settle the dispute before being permitted to sell their shares. The court held that the restraint was unreasonable because it forced shareholders to chose between selling their property and obtaining legal redress from the co-op and the benefit of the restraint to the co-op did not outweigh its adverse impact on selling shareholders.

Floor Prices

A floor price is the minimum price for which co-op shares can be sold. Board imposition of a floor price can create a conflict between the fiduciary duty a board owes to all of its shareholders and a shareholder's right to sell.

In *Oakley v. Longview Owners Incorporated,*[7] a case of first impression, a shareholder sued the board for refusing to allow her to sell her shares for less than the floor price adopted by the board. Although recognizing that sales of co-op shares may be reasonably restrained, the court ruled against the board and held that the restraint at issue was a prohibition against transferability. The court reasoned that the floor price created a restraint dependent upon market forces beyond the control of the shareholder or the co-op. The restriction thus created "an open-ended and potentially longlasting prohibition [on transfer],[8]" and was therefore an unreasonable restraint on alienation.

However, the *Oakley* court relied on how the floor price was determined—it was based on appraisals of only two apartments in a 160-unit complex—and that shareholders received no prior notice of its adoption. Query whether the outcome would have been different if a wellgrounded valuation methodology had determined the floor price. Further, the court noted that the board had no authority to impose a floor price—such authority was not in the co-op's bylaws, certificate of incorporation or proprietary lease—and shareholders were not asked to vote on the floor price.

The court's decision that the restraint unreasonably prohibited transferability suggests that it would be unlikely to find a floor price reasonable even if it were included in the co-op's governing documents. Nevertheless, shareholder action in adopting a floor price might have resulted in a different outcome.

If a board develops a reliable mechanism to memorialize the reason for a below-market sale, it should not need to use floor price to disallow an apartment sale.

In *Marine Midland Bank v. White Oak Cooperative Housing Corporation*[9] the court again held that forcing a shareholder to sell shares at a price set by a board is an unreasonable restraint on alienation. As in *Oakley*, the *Marine Midland* court noted that the price set by the board may have no reasonable relationship to market price. The court also explained that the restriction was unfair because it forced the shareholder to pay maintenance charges until the shares were sold. If the shareholder stopped paying maintenance, it would risk losing its investment in the co-op.

Further, the *Marine Midland* court held that the board could not reject a purchaser due to a low share price. The court explained that, although boards may lawfully reject purchasers for any or no non-discriminatory reason, the share price had no bearing on the purchaser. Thus, board disapproval of a transfer because of price would not be a rejection of the purchaser, but an impermissible rejection of the terms of the sale. However, challenges to disapproval based on sale price which are brought by purchasers are routinely dismissed.

In *Levine v. Yokell,*[10] a rejected purchaser claimed wrongful disapproval, alleging that the board found the purchase price too low and feared it would devalue their own apartments. The court held that the board owed no duty to the purchaser and dismissed the claim; the Appellate Division, First Department unanimously affirmed the dismissal.

Importantly, however, the *Marine Midland* court indicated that a board option to buy shares from a selling shareholder would not constitute an unreasonable restraint on alienation, so long as—if the board did not exercise its option—the shareholder could sell for any price.[11] Further, courts have implicitly held that a co-op board's right of first refusal is not an unreasonable restraint on alienation.

In *Basharat Jamil v. Southridge Coop.*,[12] the court upheld the co-op's right of first option to purchase shares where a selling shareholder sought to sell his shares without affording the co-op the first opportunity to purchase them. In addition, while New York law generally requires that transfer restrictions appear conspicuously on the face of the share certificate, co-op corporations are exempt. Co-op share transfer restrictions can be stated in the co-op's "record"—the bylaws and proprietary lease, which evidences and defines the relationship between the shareholder and the co-op.[13] This exemption further supports the legitimacy of a co-op option or right of first offer to purchase shares from a selling shareholder.

This buy-back opportunity may provide boards with a lawful vehicle to keep share prices high. However, exercise of the option may not run afoul of antidiscrimination laws. In *Cohen v. Seward Park Housing Corporation,*[14] a board disapproved the purchase of an additional apartment by shareholders. The shareholders sued, challenging the board's exercise of its right of first refusal as discriminatory because other shareholders were permitted to purchase similar apartments at prices equal to or below plaintiffs' purchase price. The court denied the board's motion to dismiss the complaint, holding that the shareholders' allegations stated a claim for unequal treatment which is not protected from challenge under the business judgment rule.

Recommendations

Co-op boards should not use a floor price to disallow a transfer of shares and may seek other ways to prevent below-market sales. For example, the board may seek to amend the co-op's foundation documents to give it an option or right of first refusal to purchase shares that are on the market, which may require shareholder action. If shares are being sold for less than what the board deems appropriate, so long as its actions are not discriminatory, it can exercise the option and purchase the shares and resell them to a buyer willing to pay more.

The board could also disallow a transfer on other, non-discriminatory grounds, including a buyer's finances, credit rating and litigation history, personal impressions from an interview or the purchase application, adverse business or social references, or other indicators that the applicant would negatively affect the co-op.[15]

However, if a board nonetheless seeks to impose a floor price, it should seek shareholder approval, incorporate the floor price into the co-op's foundation documents and notify shareholders of its adoption. While doing so will not necessarily insulate the floor price from challenge, courts tend to look more favorably on sale restrictions that are imposed by shareholder action.

Finally, the reason boards are concerned about transfer prices is that a low price frequently signals to subsequent purchasers a decline in the value of co-op shares/apartments. The low sales price becomes a problem if it does not reflect the true value of a typical apartment. For example, shares may be sold at a low price because the apartment was not in pristine condition or because the seller had purchased a new home and was anxious to sell.

To avoid such problems, boards and managers should make sure the brokerage community notes the reasons for a below-market sale. Thus, if shares are sold at a discount because an apartment needs significant repairs, subsequent purchasers would know the reason. Presumably, if a subsequent purchaser knows the circumstances surrounding a belowmarket sale, that sale should not affect the price of a later sale so long as the physical conditions of the units are different. Therefore, if a board develops a reliable mechanism to memorialize the reason for a below-market sale, it should not need to use floor price to disallow an apartment sale.

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1. 75 N.Y.2d 530 (1990).
2. Id. at 537.
3. *Penthouse Properties v. 1158 Fifth Avenue Inc.*, 256 A.D. 685 (1st Dept. 1939).
4. *Weisner v. 791 Park Ave. Corp.*, 6 N.Y.2d 426 (1959); *40 West 67th Street v. Pullman*, 100 N.Y. 2d 142 (2003).
5. See, *Mogulescu v. 255 West 98th Street Owners Corp.*, 135 A.D. 2d (1st Dept. 1988), appeal dismissed, 73 N.Y. 2d 868 (1989).
6.155 Misc. 2d 433 (Sup. Ct. N.Y. County 1992).
7. 165 Misc. 2d 192 (Sup. Ct. Westchester County 1995).
8. Id. at 195.
9. NYLJ, March 19, 1997, at 31, col. 5 (Sup. Ct. Westchester County).
10. 245 A.D.2d 138 (1st Dept. 1997).
11. See, e.g. *524 East Tenants Corp., v. Preheim*, NYLJ, Dec. 4, 1991, at 22, col. 2 (Sup. Ct. N.Y. County 1991) (co-op's resale policy held invalid because it did not permit shareholder to sell in the open market if board did not exercise its option). It should be noted that federal and state financed housing cooperatives may restrict the profits of a selling shareholder. See, e.g., Priv. Housing Finance Law §§31-a, 85-b, 128; *Zilberfein v. Palmer Terrace Cooperative Inc.*, NYLJ, Nov. 12, 2003, at 21, col. 1 (Sup. Ct. Westchester County).
12. 102 Misc.2d 404 (App. Term 2d Dept. 1979), aff'd, 77 A.D.2d 822 (2d Dept. 1980), cert. denied, 450 U.S. 919 (1981).
13. UCC §8-204(3) (McKinney 2002). Seealso UCC §9-102 at (27-e) for definition of "Cooperative record"—"those records which, as a whole, evidence cooperative interests and define the mutual rights and obligations of the owners of the cooperative interests and the cooperative organization."
14. 7 Misc. 3d 1015 (Sup. Ct. N.Y. County 2005).
15. See, generally, Richard Siegler, "Coop Apartment Transfers: Rejecting an Applicant," NYLJ, May 2, 2001 at 3, col. 1.

A condominium board of managers, on the other hand, may not prevent the transfer of a unit for any reason. Instead, the condominium can exercise its traditional right of first refusal—to match a bona fide third-party offer—which must be exercised within a reasonable period of time—a rarely exercised right but one that is lawful. See, *Anderson v. 50 East 72nd Street Condominium*, 119 A.D. 2d 73 (1st Dept. 1986). If the board of managers decides not to exercise its right, the board no longer has a say about whom the property is transferred to and on what terms. However, see, *Board of Managers of Kingsley Condominium v. Villinvestment A.V.V.*, NYLJ, Aug. 7, 2003, at 18 col. 6 (Sup. Ct. N.Y. County), where the board challenged whether the third-party offer was bona fide because it was allegedly priced dramatically less than comparable prices for similar units. The court rejected the board's challenge for lack of evidence, but query whether the challenge would have succeeded—and thereby relieved the board from either exercising its right of first refusal or issuing a waiver of same—if the evidence demonstrated that the offer was not bona fide because it was indeed significantly lower than comparable prices for similar units. See generally, Siegler and Talel, Condominiums: Restraints on Alienation, NYLJ, May 2, 2007, at 3, col. 1.