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Reallocation of Co-op Shares


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COUNSEL TO cooperative housing corporations are frequently asked for advice by boards and managers of co-ops regarding a response to a shareholder's demand for reallocation of shares for a co-op apartment. This demand is usually triggered by a shareholder's claim that the number of shares assigned to the apartment is excessive and, therefore, pursuant to the appurtenant proprietary lease, results in higher maintenance charges than is warranted.

The allocation of shares to a particular apartment in the building owned by the co-op is fundamental to the workings of the co-op. Share allocation determines important shareholder rights — the number of votes to be cast in director elections, modification of the proprietary lease and the value of an apartment on liquidation of the co-op as well as shareholder obligations for maintenance charges, assessments or sublet fees payable by the shareholder.

Importantly, no reported appellate decision in New York has required the reallocation of co-op shares. Indeed, such claims are routinely rejected. Nonetheless, reallocation demands continue to be made on co-op boards and management and to require judicial attention.

This column examines the courts' reasoning and analysis, some of which may have contributed to a perceived lack of finality on this subject.

Initial Share Allocation

The co-op's share allocation for each space is generally established by the sponsor in the co-op offering plan. The factors that enter into such allocation include the apartment's square footage, location/floor within the building and amenities (such as a balcony or roof or terrace use). However, other factors may be considered (such as layout, and views) because there is no legally mandated allocation requirement that must be followed. Indeed, the New York State Department of Law, which determines whether to accept a co-op offering plan for filing and allow the offering of apartments for sale, has no rules or guidelines with regard to share allocation. The only share-allocation related information that is generally included in a co-op offering plan, other than the allocations themselves, is an opinion from tax counsel that the co-op is expected to be in compliance with §216 of the Internal Revenue Code,[1] which governs the tax deductibility by shareholders of the real estate taxes and interest paid by the co-op.

However, §216 of the Internal Revenue Code does not mandate a set method of proportional distribution of shares in order to obtain the tax benefits of that provision for co-op shareholders. The code provides that co-op shareholders are entitled to a tax deduction for the co-op's real estate taxes and interest expense based on their "proportionate share" of the co-op's shares, if the shares allocated to each apartment bear a "reasonable relationship" to the apartment's "portion" of the value of the building.[2] However, the code does not prescribe a specific method for apportioning shares. It leaves the initial share allocation to the sponsor of the co-op offering plan.

Subsequent to the initial offering, co-op boards are generally empowered by the bylaws to issue and sell additional shares. Not infrequently, co-op boards do so, selling as apartments or professional offices previously unused or newly created space within the building including portions of corridors and terrace additions. The share allocation made by boards for such new space is similarly unregulated by statute.

Condominiums, on the other hand, are governed by statutory requirements to establish a common interest allocable to each unit.[3] The New York Condominium Act provides that each unit of a condominium is allotted a "common interest" proportional to the aggregate interests of all other units. It enumerates the factors that determine proportionality, such as market value, equality, size of the unit or a combination of various factors.[4] With no comparable requirement, developers and co-op boards have ample discretion.

The Contract

The proprietary lease memorializes the number of shares allocated to an apartment and provides that the rent (maintenance charges) and additional rent shall be equal to the proportion that the number of shares allocated to the apartment bears to the corporation's total issued and outstanding shares.

Importantly, the proprietary lease typically prohibits any increase in a shareholder's proportionate share of maintenance without express consent. The issuance of new shares by a board does not violate this contractual prohibition. By increasing the corporation's issued and outstanding shares, a shareholder's proportionate share of maintenance is never increased; indeed, in some cases it may be reduced.

Case Law: The Contract Governs

Considered against this background, successful challengers to a share allocation — at least one that would increase other shareholders' proportionate share of maintenance — must establish a legal right to rescind or reform their contract with the co-op, i.e., the proprietary lease.

However, courts are very reluctant to modify contracts. Contracts are voluntary and the parties are held to the bargain if they entered into it knowingly. Thus, if a co-op owner entered into the contract with knowledge of the share allocation for the apartment, a court will hold the claimant to the bargain and reject a share reallocation claim.

In *Abrons v. 879 Park Ave. Corp.*,[5] plaintiff purchased her apartment in 1981 but claimed she first learned in 1990 that more shares were

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allocated to her apartment than to much larger apartments. In 1991, she sued to reform the proprietary lease and reallocate the shares for each apartment in the building, although the shares had been allocated 43 years earlier. The court dismissed the complaint based on statute of limitations, holding that plaintiff's rescission/reformation claim "is eons too late."[6] Plaintiff knew what she was buying; there was no mutual mistake; instability would result if all co-op shares were reallocated; and it would be difficult, 43 years later, to determine what factors influenced the initial allocation of shares.

In *Glassmeyer v. 310 Lexington Avenue*,[7] a unanimous Appellate Division summarily dismissed a complaint seeking to decrease shares assigned to an apartment because it would require reallocation and thus additional maintenance to other shareholders. Plaintiffs were admittedly aware of the share allocation for many years prior to their purchase. While the court also relied on the business judgment rule as precluding judicial inquiry, since the challenge appears to have been to an initial share allocation embodied in the proprietary lease, such reliance creates confusion. As discussed below, a board has no discretion to act where a reallocation increases other shareholders' obligations, in breach of the proprietary lease. The business judgment rule simply has no place in the analysis.

However, where mutual mistake can be established, courts have allowed a reallocation claim. In *Goodman v. 225 East 74th Apartments Corp.*,[8] plaintiffs sued to reform their proprietary lease and reduce the shares allocated to an apartment purchased in 1985 from the sponsor, claiming that in 1995 (the apartment having been occupied by a rent-regulated tenant until then), they first learned they had purchased a studio apartment, not a two-bedroom apartment as described in the offering plan. The court denied the co-op's motion to dismiss the lawsuit as time-barred, holding that the co-op's failure to correct the sponsor's 1985 mistake was a continuing wrong which tolled the statute of limitations and permitted a reformation claim to be asserted in 1997.

Plaintiffs' claim for breach of fiduciary duty was also sustained. However, challenges to an initial co-op plan share allocation — which is embedded in a proprietary lease that prohibits increases to other shareholders' maintenance without their consent — do not implicate fiduciary duty or the business judgment rule.

Indeed, the law is clear that a board cannot breach the proprietary lease between the co-op and the shareholder in the guise of exercising its discretion under the business judgment rule.[9] Therefore, a share reallocation by a board which increases other shareholders' maintenance would be a breach of contract — not a decision protected by the business judgment rule — actionable as such by the other shareholders.

However, the business judgment rule does play an important role where the challenged allocation was made by a board issuing shares for new space. In 1990, the Court of Appeals decided *Levandusky v. One Fifth Ave.*,[10] and adopted the business judgment rule standard for judicial review of decisions by boards of co-op housing corporations. The business judgment rule prohibits judicial inquiry into actions of corporate directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes. Expanding judicial deference to co-op board decisions makes the business judgment rule the single greatest obstacle facing shareholders in reallocation disputes.[11]

In *Biamonte v. 55-57 East 76th Street*,[12] the board adopted a new proprietary lease when the original lease expired; the number of issued and outstanding shares and formula for calculating maintenance was retained. Plaintiff sued for breach of fiduciary duty, arguing that her apartment was smaller than others having the same share allocation. The court summarily dismissed the lawsuit, concluding that the board exercised honest judgment in adopting the new proprietary lease and the business judgment rule therefore barred judicial inquiry. The court noted that plaintiff and her attorney had access to the corporation's records prior to her 1971 purchase and were therefore aware of the share and maintenance structure.

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The same theme was echoed by the Appellate Division in *Cohn v. 120 Owners*.[13] There, a co-op allocated shares to and sold five professional apartments; plaintiff purchased one. Promptly after closing, he sued, claiming that the shares allocated to his apartment were excessive and challenging the share reduction for the other professional apartments. The co-op argued that the shares were allocated based on apartment size and amenities and a unanimous Appellate Division dismissed the lawsuit, finding the co-op's reallocation to be a proper exercise of business judgment. As in *Biamonte*, plaintiff purchased the apartment knowing of the share allocations.

Finally, in *Schultz v. 400 Cooperative Corp.*,[14] the Appellate Division in 2002 sounded what should be the death-knell for challenges to share allocations by co-ops. Plaintiffs purchased a professional apartment from the co-op in 1985 and subsequently negotiated a share increase in lieu of a monthly professional fee surcharge. By 1996, the share increase generated maintenance payments that exceeded the surcharge. When the board refused to reduce the allocated shares, plaintiffs sued for reformation.

A unanimous Appellate Division reversed the lower court's grant of reformation, because plaintiffs freely made and abided by their contract for over a decade before seeking judicial intervention and summarily dismissed the lawsuit. The court also relied on the business judgment rule in disposing of allegations of favoritism and breach of fiduciary duty, because plaintiffs suffered no harm from the alleged favoritism and there was no significant discrepancy in the share allocations of comparable units.

The business judgment rule is a difficult if not impossible hurdle to overcome in share reallocation claims. Case law teaches that it is likely a waste of time and money for a shareholder to initiate such a lawsuit.

Conclusion

Courts respect the contract between a co-op and its shareholders and decline to rescind or modify the original share allocation embodied in the proprietary lease. Courts similarly respect a shareholder's contract of purchase and where it was entered into with knowledge of the share allocation, courts will reject a challenge. Where new co-op shares are issued and allocated by a board, courts defer to such board determinations under the business judgment rule and, in the absence of bad faith or self-dealing, invariably reject reallocation claims. Caveat emptor is the order of the day!

(1) IRC §216 (1998).
(2) Id.
(3) N.Y. Real Prop.Law §339(i) (McKinney 1989)
(4) Id.
(5) NYLJ, Oct. 9, 1991, p. 21, col. 6 (Sup. Ct. N.Y. County 1991)
(6) Id.
(7) 647 NYS2d 784 (1st Dept. 1996).
(8) NYLJ, Aug. 19, 1997, p. 22, col. 3 (Sup. Ct. N.Y. County 1997).
(9) See *Dinicu v. Groff Studios Corp.*, 257 AD2d 218, 223 (1st Dept. 1999). (Business judgment rule did not protect board's refusal to execute application for certificate of occupancy to reflect plaintiff's use of the premises, execution of which specifically required under proprietary lease); *Ludwig v. 25 Plaza Tenants Corp.*, 184 AD2d 623 (2d Dept. 1992) (where proprietary lease expressly prohibits board from unreasonably withholding consent to a sublease of less than 12 months and board nonetheless withholds consent, board's actions violate the proprietary lease and the business judgment rule is not applicable.)
(10) 75 NY2d 530 (1990).
(11) See generally, Siegler, Richard and Talel, Eva, "'Levandusky' Update: Slim Odds on Reversing Board Decisions," NYLJ, Sept. 4, 2002, at 3, col. 1.
(12) NYLJ, July 7, 1990, p. 18, col. 2. (Sup. Ct. N.Y. County 1990).
(13) NYLJ, June 23, 1993, p. 5, col. 1 (Sup. Ct. N.Y. County 1993).
(14) 736 NYS2d 9 (1st Dept. 2002)