

CLIENT ADVISORY

JUNE 2002

EXPANDING THE APPLICATION OF THE "BUSINESS JUDGMENT" RULE

Last month, the Appellate Division, 1st Department, revisited the business judgment rule in the context of the judicial review of a co-op board's decision to evict one of its shareholders for "objectionable behavior". If upheld on appeal, this decision could be a formidable tool for boards dealing with shareholder conduct-related issues because claims of "objectionable behavior" by shareholders are a common problem faced by cooperative and condominium boards.

In 40 West 67th Street v. Pullman, (NYLJ, 5/24/02), a shareholder apparently undertook a course of conduct that more than two-thirds of his fellow shareholders found sufficiently objectionable to justify his eviction. The shareholder is described as having made numerous requests to change the building's facilities and services, all rejected by the board, and having threatened to sue the president and the building's managing agent for failing to abate a noise problem in the apartment directly above his own. Apparently, the shareholder claimed the upstairs tenant was running a book binding business and turned up the volume on his radio and television. The board investigated and found no television, stereo or evidence of a business. The former tenants of the shareholder's apartment were questioned and claimed they never heard excessive noise coming from upstairs. The noise dispute then escalated to physical violence, resulting in the arrest of the upstairs neighbor for an assault in the building's elevator. Over the next year, the shareholder filed four (4) lawsuits against the upstairs neighbor, the cooperative corporation and the managing agent, and passed out leaflets complaining of the assault and urging the neighbor's eviction. However, the board notified him that he was in breach of his proprietary lease due to illegal renovations and his failure to carpet his floor. The board then voted unanimously to evict the shareholder and scheduled a special meeting of all shareholders for a required vote. The proprietary lease provided that a shareholder could be evicted for objectionable conduct by a vote of not less than two-thirds of all shareholders. The shareholder was notified of the special meeting, but failed to attend. His fellow shareholders voted resoundingly for his eviction. The shareholder then refused to vacate his unit, and the board brought suit for possession. Supreme Court Justice Marilyn Shafer denied the cooperative's request for summary judgment, finding that it was the place of the court to determine whether the shareholder's conduct was sufficiently objectionable to justify his eviction. On appeal, the Appellate Division, 1st Department, modified Justice Shafer's ruling, granting the cooperative summary judgment evicting the shareholder, and remanded the case for a hearing on use, occupancy, legal fees and costs.

A majority of the presiding justices of the Appellate Division held that the business judgment rule should be applied to determinations made by a cooperative's board such as the decision to evict this shareholder, placing the burden upon the shareholder to demonstrate that the board breached its fiduciary duty by acting in an illegal, discriminatory or bad faith manner. The majority relied heavily upon an earlier Court of Appeals decision, (Levandusky v. One Fifth Avenue Apartment Corp., (5 N.Y.2d 530, C.A., 1990)). The Court of Appeals' reasoning in Levandusky was, in part, that the application of the business judgment rule would avoid unnecessary confusion that would be generated by prescribing different standards for different categories of issues coming before boards. The case will likely go before

New York's highest court, because several Appellate Division justices strongly opposed the decision. The dissenting justices believe that the decision improperly overrules the statutory protections afforded to tenants by Section 711 of the Real Property Actions and Proceedings Law, which would require the board to present competent evidence of the shareholder's objectionable conduct to the court, rather than the court reviewing the board's decision only when evidence is presented by the shareholder that the board acted in an illegal, discriminatory or bad faith manner. We will continue to follow this matter and include developments in future issues of our Client Advisory.

CAN POST 9/11 TERRORISM EXCLUSIONS RESULT IN MORTGAGE DEFAULTS?

At our November 15, 2001 seminar on insurance coverage issues, we discussed potential changes to insurance coverages which may result from September 11, 2001, and the impact those changes may have on cooperatives, condominiums and real estate owners. Prominent in those discussions was the possible exclusion of acts of terrorism, and the possibility that a mortgage lender may then declare a default on its mortgage unless separate terrorism insurance is purchased, even at a prohibitive cost. We discussed that a mortgage lender's insistence upon coverage for acts of terrorism may depend upon factors such as the location of the building, its notoriety, its tenants, or the value of the property, and the language of the particular mortgage. This topic is now the subject of a reported opinion, which, if upheld on appeal, could force many cooperatives, condominiums or real estate owners to incur substantial additional insurance expenses or risk being in default on their mortgage.

The case of Four Times Square Associates, L.L.C. v. Cigna Investments, Inc. (NYLJ, May 7, 2002, p. 18, col. 1) illustrates the potential problem facing all mortgage borrowers in New York. In April, 2002, LaSalle National Bank (the "Bank"), the holder of a \$430,000,000 mortgage on the Conde Nast building located at Four Times Square, notified Four Times Square Associates, L.L.C. (the "Owner"), that it was in default on its mortgage because its insurance policy no longer covered acts of terrorism. The Owner had been paying a premium of \$500,000 per year for an "all risk" policy, which the insurer had recently amended to exclude acts of terrorism. This mortgage provided that if the Owner were in default, the Bank could pay the premium out of the Owner's monies with interest at the prime rate plus 2%. The Owner disputed the Bank's right to require terrorism insurance, relying upon the language in the Bank's mortgage that requires "all risk" coverage but does not specifically require terrorism insurance. The Owner immediately went to court for an injunction, seeking to prevent the Bank from seizing \$3,200,000 from building rents in order to pay one year's premium on the terrorism policy. The Bank thought the premium could actually be as high as \$5 million dollars per year. Justice Harold Tompkins granted the Owner a temporary injunction. However, at a hearing several days later, Justice Tompkins partially vacated his injunction permitting the Bank to seize the money to pay the premium. Justice Tompkins stated, "while \$3,200,000 is significant, it is monetarily compensable and therefore not irreparable harm to the Owner. In the current circumstances, terrorism insurance, which was inexpensive prior to September 11, is now at a premium price. It is however available and it is prudent for an owner to require it". Thus, Justice Tompkins concluded that the potential harm from a lack of insurance outweighed the Owner's potential damage caused by purchasing the coverage.

The Owner appealed Justice Tompkins' decision, and was granted a temporary injunction by the Appellate Division. The matter has since been submitted to Justice Tompkins and awaits his decision on the merits of the case. We will continue to follow this matter and include developments in future issues of our Client Advisory.