
CLIENT ADVISORY

MARCH 2009

COURT PERMITS DISCOVERY TO PROCEED ON CLAIM THAT COOPERATIVE BOARD BREACHED DUTY BY EXTENDING LEASE

Decisions made by a Cooperative Board of Directors or Condominium Board of Managers are ordinarily entitled to the protection of the “business judgment rule,” meaning that litigations brought by shareholders or unit owners seeking to second-guess the board’s good-faith business decisions are unlikely to succeed. However, the business judgment rule has its limits, as demonstrated by Allannic v. Levin, 57 A.D.3d 443, 870 N.Y.S.2d 286 (1st Dep’t Dec. 30, 2008).

In this case, shareholders of a Cooperative sued the Board as well as a tenant in the building, alleging that the Board’s renewal of the tenant’s master lease for commercial space constituted a breach of the Board’s fiduciary duties. The facts, as found by a lower court, were that the Board had become concerned in 2000 that charging market rent on the commercial space would endanger the Cooperative’s compliance with the “80/20 rule” which, as then in effect, would have deprived the Cooperative and its shareholders of tax benefits if more than 20% of the Cooperative’s income were derived from sources other than tenant-shareholders. To avoid this danger, the Board voted to lease the commercial space to a limited liability company (LLC), which would be owned proportionately by each of the seven shareholders in the Cooperative. The Cooperative would charge the LLC rent amounting to less than 20% of the Cooperative’s income, but the LLC could then lease out the space to a third-party tenant for a market rent, and the members of the LLC would receive the difference.

Subsequently, however, the owners of two of the cooperative units sold their cooperative shares in transactions that did not include the transfer of their shares in the LLC. As a result, the ownership of the Cooperative and of the LLC was no longer identical. Thereafter, it was proposed that the Cooperative extend the LLC’s favorable lease for an additional 13 years. The motion was supported by board members who were also members of the LLC, but opposed by members who were not. The non-members then sued the Cooperative and the board members who had approved the extension for breach of the fiduciary duty that they owed to all shareholders of the Cooperative, claiming that the space could have been re-let to a new LLC comprised of all the current cooperative shareholders. The lower court dismissed the case, finding that there was a legitimate business purpose for the extension granted to the existing LLC.

On appeal, the appellate court reinstated the case and directed that discovery take place. In the Appellate Division’s words, “[t]he business judgment rule does not foreclose inquiry into the disinterested independence of th[e] members of the board....” Rather, “[t]he rule shields [the] directors only if they possess a disinterested independence and do not have dual relations that prevent an unprejudicial exercise of judgment.” Here, the court concluded, “[t]he defendant housing cooperative board members were not disinterested members when they voted to enter into a lease extension of a master lease pursuant to which all of the shareholders would not be treated fairly and evenly.” Therefore, the court directed further proceedings on “whether the board engaged in self-dealing and whether its failure to treat all shareholders fairly and equally constitutes a breach of its fiduciary duties.”

COOPERATIVE SHAREHOLDER FORFEITS SUBTENANT'S SECURITY DEPOSIT BY FAILING TO PLACE IT IN AN INTEREST-BEARING ACCOUNT

A cooperative shareholder that took a security deposit from a subtenant, but then failed to place it in a segregated interest-bearing account, must immediately return the security deposit to the subtenant despite any claims the shareholder-landlord might have against the subtenant for damage to the unit. So holds the decision in Vidipax, LLC v. Brown Bear Realty Corp., 2009 WL 38066, 2009 N.Y. Slip Op. 50016 (Sup. Ct. N.Y. Co. Jan. 7, 2009).

In this case, the subtenant sublet a cooperative unit under an assignment of a sublease from the plaintiff, which was the tenant-shareholder of a proprietary lease in a cooperative. As security under the sublease, in 2000, the subtenant gave the tenant-shareholder, its direct landlord, a security deposit of \$75,000. However, the landlord failed to deposit the security deposit in a segregated interest-bearing bank account, as required under General Obligations Law § 7-103. Instead, the landlord apparently commingled the \$75,000 with its own funds. When the sublease ended, the landlord claimed that it was entitled to keep the security deposit to compensate for damage and for unauthorized alterations to the unit. The subtenant contended that the landlord's commingling of the security deposit with its own funds entitled the subtenant to immediate return of the security deposit.

The court sided with the subtenant and demanded that the landlord (tenant-shareholder) immediately repay the \$75,000 to the subtenant, together with interest from 2000 to date. In its decision, the court determined that leases and subleases of cooperative apartments are subject to the requirements of Section 7-103. The court noted that the landlord could continue to pursue its claims against the subtenant for damages and unauthorized alterations. However, in addition to having to pay substantial interest, the landlord will not have the protection of holding the deposit as security for any judgment it might ultimately recover against the subtenant.

LEGISLATURE ADOPTS NEW REQUIREMENTS FOR POWERS OF ATTORNEY; EFFECTIVE DATE DELAYED

The New York State Legislature has recently adopted extensive amendments to provisions of the General Obligations Law dealing with powers of attorney. Among other things, the amendments modify the statutory provisions prescribing the language contained in statutory short-form powers of attorney; declare that the holder of a power of attorney owes a fiduciary duty to the principal; provide that a power of attorney granted by a natural person continues in effect despite the incapacity of the principal (i.e., is "durable") unless otherwise specified; require that the signatures of both the principal and the holder or holders of the power of attorney be acknowledged in the manner prescribed for acknowledgement of a conveyance of real property; make it unlawful for a third party to refuse to recognize a duly executed power of attorney; and provide that special proceedings may be brought in court where necessary to resolve issues arising from powers of attorney. The new statute also contains numerous other changes. Anyone affected by or relying on a power of attorney, whether as principal, agent, or a third party, should carefully review the new statutory provisions or consult with counsel as to their impact.

As originally adopted, most provisions of the new statute would have gone into effect on March 1, 2009. On February 25, 2009, Governor Paterson signed a law postponing the effective date of most of the amendments to September 1, 2009, to allow additional time for lawyers and interested parties to familiarize themselves with the new requirements. However, a few provisions, including the declaration that a holder of a power of attorney is a fiduciary, have already taken effect.