Realty Case Study:

Shareholder Tenants and Holders of Unsold Shares - The Turning Tide

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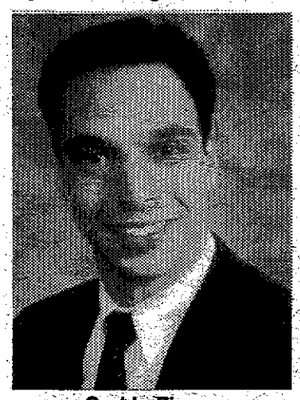

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WHITE PLAINS — Shareholder-Tenants and Holders of Unsold Shares working together for the betterment of the cooperative corporation and the building(s) which the Shareholder-Tenants call home.

Why not?

The Holder of Unsold Shares and the Shareholder-Tenants all stand to gain by maintaining the cooperative building(s), upgrading the building(s) and insuring that the cooperative building(s) are kept in excellent condition.

If the building is in good condition, the prices of the apartments and stock attributable thereto will increase accordingly. Of course, higher sales prices will benefit the Holder of Unsold Shares in the same way that they will benefit Shareholder-Tenants. Further, the Holder of Unsold Shares, if renting apartments, should be able to command higher rents as the building is improved.

A Closer Look

However, upon closer inspection the above hypothesis has tended to be incorrect. The interests of the Sponsors and Holders of Unsold Shares frequently diverge from those of the Tenant-Shareholders rather than coalesce. To begin with, the apartments owned by the Sponsor or Holder of Unsold Shares may be the subject of some form of rent regulation.

In such event the Sponsor may not receive rent increases for improvements or maintenance in the building or for other expenditures which the Tenant-Shareholders find appropriate or even necessary. Moreover, given the whims of the real estate market, the increase in value attributable to the maintenance of the cooperative building(s) is by no means assured.

In any event, the experience of many cooperatives has generally established, beyond any doubt, that the interests of the Tenant-Shareholders remain distinct from those of the Sponsor or Holder of Unsold Shares.

Perhaps the most important acknowledgment that the interests of the Tenant-Shareholders are distinct from those of the Holder of Unsold Shares is the fact that there are a multitude of regulations and provisions in offering plans and proprietary leases that provide for different treatment of the Tenant-Shareholders and the Holder of Unsold Shares.

This contrasting treatment frequently resulted in disputes and litigation between the Tenant-Shareholders and Holders of Unsold Shares regarding sublet approvals, sublet fees, flip taxes, sale approvals, voting rights and the composition of the Board of Directors.

On these various fronts the Holders of Unsold Shares have frequently been provided "preferential" treatment which has been upheld by the Courts.

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The case of Susser v. 200 East 36th Owners Corp., 1999 Slip Op. 06178, 692 NYS2d 334, is instructive.

In that case a tenant shareholder challenged the cooperative's right to charge sublet fees on the basis that the exemption of holders of unsold shares from said charges constituted disparate treatment of holders of the same class of stock. The tenant shareholder claimed that the treatment violated New York Business Corporation Law Section 501(c). The Appellate Division First Department rejected the tenant shareholders claim.

The Court held that considering other legal requirements placed on a holder of unsold shares, as well as public policies, and through the intent of the legislature, there was "no basis to conclude that the failure to afford them (tenant shareholders) the same exemption as the sponsor deprives them of equal treatment within the meaning of Business Corporation Law Section 501(c)" of Susser v. 200 East 36th Owners Corp, supra at 335.

Recent Events

Recently, however, the Tenant-Shareholders in at least two cases have established that the Holder of Unsold Shares is not in fact a "Holder of Unsold Shares." Obviously, this seeming anomaly bears explanation.

Many cooperatives were "converted" from buildings owned by a "Sponsor" to cooperative ownership. The Sponsor retains the shares to the units that the Sponsor has not sold, and as to those units the Sponsor is the "Holder of Unsold Shares." This proposition remains unchallenged.

However, in many instances the Sponsor subsequently sells his shares and apartments to another entity for investment purposes. This entity may intend solely to own the apartments for investment, including continuing rental and possible future sale. Since the sale of the Sponsor's units and shares were to another investor and not to be occupied by said investor, it has widely been assumed that the investor inherits the status of Holder of Unsold Shares.

Therein lies the basis for the recent successful challenges by Tenant-Shareholders. 13 NYCRR 18.3(w) addresses "Unsold Shares" and sets forth a number of requirements for those seeking to be classified as a "Holder of Unsold Shares."

In subsection 1, it states that "a holder of unsold shares is the sponsor or any individual designated to hold unsold shares by the sponsor" (emphasis added). It requires that the investor be "designated" by the Sponsor as the Holder of Unsold Shares. By way of further limitation in this section, upon purchase for occupancy the shares shall cease to be unsold shares.

Subsection 3 requires that the "sponsor must guarantee the payment of all maintenance charges and assessments due from a Holder of Unsold Shares." A Holder of Unsold Shares must also comply with the trust fund and escrow provisions of General Business Law sections 352-h and 352-e(2)(b). These requirements pertain to the deposit of certain moneys in escrow.

Moreover, the party asserting status as a Holder of Unsold Shares must have registered as a "broker-dealer pursuant to General Business Law section 359-e" pursuant to subsection 10 of 13 NYCRR 18.3(w).

The Holder of Unsold Shares, under subsection 10, must also "furnish to the Department of Law all information required for a principal of the sponsor by section 18.2-(c)(4)(iv) of this Part." In the same vein the Holder of Unsold Shares must amend the offering plan on an ongoing basis until all of the unsold shares have been purchased by bona fide purchasers (13 NYCRR 18.3(w)(11).

An Attorney General's Office Memorandum of October 6, 1987, entitled "Definition of Holder of Unsold Shares" further established what entity is in fact a "Holder of Unsold Shares" in offering a more detailed interpretation of the regulations.

"Normally, bearing the burdens associated with being a holder of unsold shares is the quid pro quo for the benefits obtained from such status" (Memorandum, P.2). More particularly, as a plan may, and frequently does, provide that the Holder of Unsold Shares does not need the consent of the Board to "use, sublet, sell, pledge or transfer unsold shares and/or does not have to pay transfer fees, and may make alterations without the consent of the board" (Memorandum, P.2), the Holder of Unsold has the indicated additional obligations.

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A Definition

The memorandum addresses the definition of the Holder of Unsold Shares. It also, in particular, notes that,as would seem apparent, the sponsor may transfer shares to parties not holders of unsold shares, and that upon the transfer of shares a party will become a holder of unsold shares if designated as such by the sponsor (Attorney General's Memorandum, 10/6/87, P. 1).

Importantly, the Memorandum set forth that "it is clear, then, that all unsold shares held by sponsor and later sold by him do not necessarily result in the grantee becoming a 'Holder of Unsold Shares' entitled to whatever benefits are associated with such status" (Memorandum, P.2).

Also critically, the Memorandum addresses the last sentence of 13 NYCRR 18.3-(w)(1), which states that "such shares shall cease to be unsold shares when purchased by a purchaser for occupancy." The Memorandum elucidates that this sentence actually provides a further limitation and does not excuse compliance with all other obligations for a holder of unsold shares. Thus, even compliance with all of the requirements for a holder of unsold shares, if purchased for occupancy, will serve to disallow status as a "holder of unsold shares."

The memorandum goes on to explain that the stated sentence requires the loss of status of Holder of Unsold Shares when an apartment owned by a holder of Unsold Shares becomes occupied by the Holder of Unsold Shares.

In that case also, the party then loses the status of Holder of Unsold Shares with reference to that apartment (Memorandum, P.2). Furthermore, the Memorandum explains the manner of the required designation of a Holder of Unsold Shares by the sponsor stating that "this 'designation' is usually evidenced by an amendment to the plan required by 13 NYCRR 18.3(w)(ii)" (Attorney General's Memorandum, 10/6/

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