# Unsold Shares – The Law Reversed…and New Problems

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"…We suspect that each new decision will bring a myriad of new problems, particularly in a day and age when the Attorney General's office is not very proactive in this field on behalf of Cooperatives."

WHITE PLAINS - Previously, your authors have written about being a Holder of Unsold Shares.

Many cooperative boards have been frustrated by the benefits accorded a "holder of unsold shares." For the uninitiated a "holder of unsold shares" is generally a successor to the Sponsor of a Cooperative and can inherit the benefits accorded a sponsor, i.e., the right to lease or sell an apartment without having to obtain the permission of the Board of Directors.

Over the years, many cases, such as Gorbatov v Gardens 75th St. Owners Corp., 247 A.D.2d 440 (2d Dept 1998) were cited in support of the proposition that certain shareholders were not holders, regardless of their claimed rights under the cooperative's governing documents, unless they also complied with regulations promulgated by the Attorney General under article 23-A of the General Business Law (the "Martin Act") and codified at 13 NYCRR Part 18.

The courts also generally held that the normal provision in a Proprietary Lease that a person remains a holder until he/she actually purchases an apartment for personal occupancy was limited. The courts determined that, contrary to the purported "holder of unsold shares'" contentions, they were not holders merely by virtue of their compliance with section 38(a) of the proprietary lease. "[Such a provision, alone, 'does not create rights ... it merely extinguishes them ' " (id. [quoting Craig v. Riverview E. Owners, 156 A.D.2d 157, 158 (1st Dept 1989) ] ).

A Memorandum by the office of the Attorney General in 1987 succinctly encapsulated all of the requirements to be a "holder of unsold shares" and Assistant Attorney General DeStephan's memo was repeatedly quoted approvingly by the Supreme and Appellate courts. The cases were legion and virtually universally followed over past years, although rarely, if ever, was the issue squarely put before New York's highest court, the Court of Appeals.

Cooperatives were feeling more comfortable with the Levandusky, Pullman and London Terrace cases giving the Boards of Directors more freedom to act without judicial interference so long as they acted in their "business judgment."

Those who could not prove that they had complied with the requirements of Part 18, to be a "holder of unsold shares" , in short, designation by a "sponsor," guaranty of maintenance by the sponsor, registration as a broker-dealer, among others, were treated as ordinary shareholders and could not utilize the special exemption from Board approval.

### Trouble

Then, last June, for the majority of cooperative boards, disaster!

In the case of Kralik v. 239 E. 79th St. Owners Corp., 5 N.Y.3d 54, 59, 799 N.Y.S.2d 433, 832 N.E.2d 707, the Court of Appeals virtually reversed 15-plus years of precedent. In a sweeping decision, the Court, as quoted by a later case, stated that:

"Contrary to the ... [Cooperative's] contention, the regulations promulgated by the Attorney General to govern the conduct of holders of unsold shares of residential cooperative corporations (see 13 NYCRR part 18) are inapplicable to the plaintiff [purported "holder of unsold shares"] "unless and until [he] offer [s][the] shares for sale to the public, and, in that event, only the Attorney General may enforce Part 18's requirements"(Kralik v. 239 E. 79th St. Owners Corp., 5 N.Y.3d 54, 59, 799 N.Y.S.2d 433, 832 N.E.2d 707).

Thus, a determination as to whether the plaintiff is a holder of unsold shares should be made "solely by applying ordinary contract principles to interpret the terms of the documents defining [his] contractual relationship with the cooperative corporation" (Kralik v. 239 E. 79th St. Owners Corp., supra at 54, 799 N.Y.S.2d 433, 832 N.E.2d 707), including the relevant offering plan, amendments to the plan, and the proprietary lease (see Riggin v. Balfour Owners Corp., 137 A.D.2d 799, 525 N.Y.S.2d 347).

Where, as here, there is nothing in the record to indicate that the plaintiff offered the shares in dispute to the public, or intended to offer them for sale, the defendant may not condition the plaintiff's status as a holder of unsold shares on his compliance with the provisions of 13 NYCRR part 18 (see Kralik v. 239 E. 79th St. Owners Corp., supra ).

The language of the relevant offering plan, plan amendments, and proprietary lease established the plaintiff's entitlement to judgment as a matter of law on the cause of action for a declaration that he is a holder of unsold shares, and thus exempt from sublet fees and the need to obtain prior sublet approval from the defendant's board of directors. The defendant raised no triable issue of fact in opposition.

### Additional Facts

In addition, there is no merit to the defendant's contention that Business Corporation Law §501(c) prohibits an offering plan or proprietary lease from exempting a holder of unsold shares from sublet fees or board-approval requirements applicable to other shareholders (see Susser v. 200 E. 36th Owners Corp., 262 A.D.2d 197, 198, 692 N.Y.S.2d 334; Mogulescu v. 255 W. 98th St. Owners Corp., 135 A.D.2d 32, 523 N.Y.S.2d 801; 1326 Apt. Corp. v. Barbosa, 147 Misc.2d 264, 268, 555 N.Y.S.2d 560).

Nor did the plaintiff breach any obligation to the defendant by failing to sell the disputed shares to a bona fide purchaser for occupancy within any given time frame (cf. 511 W. 232nd Owners Corp. v. Jennifer Realty Co., 98 N.Y.2d 144, 746 N.Y.S.2d 131, 773 N.E.2d 496; West Gate House, Inc. v. 860-870 Realty, LLC, 7 A.D.3d 412, 776 N.Y.S.2d 482)."

Thus, in one fell swoop, the Court of Appeals stated (upon the Attorney General's request in its "amicus" brief in Kralik), that only the Attorney General had the authority to question the status of a holder of unsold shares, and that regardless of whether or not a shareholder was "designated," or there was a "guaranty of maintenance" or whether or not the shareholder was set forth in an amendment as a "holder of unsold shares", or registered as a "broker-dealer" was not to be raised by the Cooperative.

Thus, a literal reading of the decision might lead one to believe that a Cooperative might not even be able to raise this defense when brought to litigation by an alleged "holder of unsold shares."

### A Series of Unanswered Questions

Your authors believe that cases that follow will not be as strictly construed and will allow leeway by a Board of Directors in appropriate cases, such as set forth below. There are, as always, questions left unanswered.

Query: In order to be a "holder of unsold shares" and have the status interpreted by ordinary contract principles, is there a requirement that the alleged "holder of unsold shares" have purchased directly from the sponsor?

We think this is a reasonable interpretation of the Court's decision since to apply "ordinary contract principles" you have to have a contract between the Sponsor and the "Holder of Unsold Shares."

Query: What about when a lender takes back shares? Is this a sale to the public?

Query: Can a person "self-designate" as a holder of unsold shares and then deny the Cooperative's ability to challenge that designation. We think a cooperative will apply the business judgment rule and it will be up to the court to reconcile.

Query: Is a sale exempt from Kralik?

It would appear from the strict language of Kralik as well as later cases that one could reasonably make this argument and that Kralik only applies in sublease situations.

Query: Is an offer from one or two people an offering to the "public" thereby rendering Kralik inapplicable?

### Answers on the Way

We should have the answer to some of these questions shortly as there are several cases, including two from our office, working their way through the system. But we suspect that each new decision will bring a myriad of new problems, particularly in a day and age when the Attorney General's office is not very proactive in this field on behalf of Cooperatives.

As the cases develop, it will be of interest to note whether or not the Courts expand on the decision of the Court of Appeals, thereby further limiting the ability of a Board of Directors in this one area to exercise its business judgment or whether there will be a loosening of the constraints so as to give full meaning to the Attorney General's regulations and the New York State Code which provided valuable guidance for determination of when a person is or is not a "holder of unsold shares."

Stay tuned!

***Editor's Note: The authors are with the law firm of Finger and Finger, A Professional Corporation. Finger and Finger is chief counsel to the Building and Realty Institute of Westchester and the Mid-Hudson Region (BRI). The firm is based in White Plains.***

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