

# TRANSFER RESTRICTIONS ON COOPERATIVE APARTMENTS: TYRANNICAL REINS OR NECESSARY RESTRAINTS?

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## I. INTRODUCTION

Cooperative apartments<sup>1</sup> offer individuals the advantages of home-ownership<sup>2</sup> while freeing them from many of the responsibilities accompanying single-family dwellings.<sup>3</sup> Due to the close proximity of dwelling units<sup>4</sup> and the financial interdependence<sup>5</sup> of tenant-sharehold-

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1. A cooperative apartment is defined as a "multi-family dwelling for members of a cooperative corporation, with each member having a stock interest in the corporation that owns the building, and by virtue of that stock interest entitled and required to receive an occupancy agreement with the corporation." TIFFANY, *THE LAW OF REAL PROPERTY* 3220 (3d ed. 1940).

2. Among the elements of home ownership that a cooperative apartment offers are the right to sole occupancy; the right to select, and the obligation to pay for, fixtures and decorations in the units; performance of tenure; a voice in the management and operation of the premises; and the right to deduct real estate taxes and mortgage interest payments. See Isaacs, *"To Buy or Not to Buy, This is the Question"* . . . *What is a Cooperative Apartment?* 13 REC. A.B. CITY N.Y. 203, 208 (1958).

3. A purchaser of a cooperative interest avoids such responsibilities as the upkeep of his yard and house. The cooperative usually hires a management group to perform these duties. Furthermore, building security devices and the presence of other cooperators provide enhanced protection from thieves and vandals.

4. Structurally, cooperative apartments are similar to apartment buildings. Individual units are typically adjacent to one another.

5. See *Penthouse Properties v. 1158 Fifth Avenue*, 256 A.D. 685, 689-92, 11

ers,<sup>6</sup> however, cooperatives act cautiously when admitting new members. To protect themselves from potentially disruptive or insolvent buyers, cooperatives condition the sale of each apartment upon the consent of a board of directors.<sup>7</sup>

Individuals denied the right to buy or sell cooperative interests have challenged the boards' legal power to withhold consent.<sup>8</sup> All courts concur that the unique nature of cooperative housing<sup>9</sup> necessitates some screening of potential tenant-shareholders.<sup>10</sup> The courts disagree, however, on the extent to which boards lawfully may exercise this power. A majority of state courts apply a reasonableness standard to test the legality of board decisions.<sup>11</sup> Conversely, New York courts allow boards of directors to exercise unlimited<sup>12</sup> discretion in determining whether to accept or reject a proposed sale. The divergent standards reflect the conflicting policy concerns among the jurisdictions. The majority view protects a cooperator's right to liquidate his inter-

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N.Y.S.2d 417, 420-23 (App. Div. 1939). A cooperative is financed by a single mortgage on the building. The corporation's ability to make mortgage payments depends upon each member meeting his periodic assessments. If one cooperator fails to pay his assessment, the others must pay the defaulter's share to avoid foreclosure. *See Note, Federal Assistance in Financing Middle-Income Cooperative Apartments*, 68 YALE L.J. 542, 597 (1958-59).

6. In this Note, the words cooperator and tenant-shareholder are used interchangeably to refer to the owner of a cooperative interest. "Tenant-shareholder" is an appropriate term because the person who purchases a cooperative interest receives a lease as well as stock in the corporation. *See infra* notes 38-45 and accompanying text.

7. Tenant-shareholders elect a board of directors. The board is vested with the power to approve or reject any sale of a cooperator's interest. This power usually is set out in either the corporation's bylaws or articles of incorporation. If the board concludes that a prospective purchaser will be disruptive to the community or unable to meet his periodic assessment, it may withhold consent and effectively prevent a tenant-shareholder from selling his cooperative interest to that prospective tenant. *See Note, Cooperative Apartment Housing*, 61 HARV. L. REV. 1407, 1416-18 (1947).

8. *See infra* notes 86-100 and accompanying text.

9. Cooperative apartments include features not found in other types of homeownership. *See supra* notes 4-5.

10. Without the ability to choose its members, cooperative housing could be eliminated. Because state legislatures have approved the cooperative housing concept, all courts agree that cooperative housing associations should have the means to screen potential members. The majority and minority views, however, differ over the amount of discretion the cooperative may exercise in rejecting an applicant. For a detailed comparison of the views, *see infra* notes 135-46 and accompanying text.

11. *See infra* notes 102-06 and accompanying text.

12. *See infra* notes 120-24 and accompanying text.

est.<sup>13</sup> In contrast, the New York view provides tenant-shareholders with an unfettered right to select their neighbors.<sup>14</sup> This position effectively prevents a cooperator from selling his interest if the board determines that the proposed buyer is unsuitable.

This Note will scrutinize both the majority and the New York positions and argue that neither adequately protects a tenant-shareholder's right to sell his cooperative interest. Part II provides an overview of cooperative apartments and explains why transfer restrictions on cooperative interests are necessary. Part III examines the different standards jurisdictions have adopted to determine the legality of restrictions. Part IV analyzes the impact that application of these standards has on cooperatives and on tenant-shareholders attempting to sell their cooperative interest. Part IV concludes by proposing an alternative standard that protects a cooperator's right to sell his interest without exposing the cooperative to additional risks.

## II. THE COOPERATIVE APARTMENT

A cooperative apartment house is a multi-unit dwelling in which each occupant possesses both an interest in the corporation owning the building and a proprietary lease entitling him to occupy a particular apartment.<sup>15</sup> Cooperative housing<sup>16</sup> developed as a result of the growing demand<sup>17</sup> for desirable city housing, coupled with the rising cost of

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13. See *infra* notes 103 and 142 and accompanying text.

14. See *infra* note 122 and accompanying text.

15. See *Sanders v. Tropicana*, 31 N.C. App. 276, 278, 229 S.E.2d 304, 307 (1976). For a broader discussion of cooperative apartments' specific features, see *infra* notes 32-35 and accompanying text.

16. The roots of modern day cooperative housing can be traced to twelfth century Germany. See *Leyser, The Ownership of Flats—A Comparative Study*, 7 INT'L & COMP. L.Q. 31, 33 (1958) Early eighteenth century France provides the earliest example of cooperative housing as it appears today. After a fire destroyed a significant portion of a city's housing, individuals displaced by the fire purchased floors in multi-level buildings to provide dwellings for their families. See *McCullough, Co-operative Apartments in Illinois*, 26 CHI. [-] KENT L. REV. 303, 304 (1947-48).

Cooperative housing did not spread to the United States until the late nineteenth century. One of the first American cooperative projects was the Barrington Apartment Association in New York City. See *Isaacs, supra* note 2, at 209. See also *Gray, The 'Revolution' of 1881 is Now in its 2d Century*, N.Y. Times, Oct. 28, 1984, § 12 (Magazine), at 61.

17. See *Bratt, Cooperative Apartments: A Survey of Legal Treatment and an Argument for Homestead Protection*, 1978 U. ILL. L.F. 759, 771-72, 785 (1978). The end of World War II brought about a shortage of urban housing. The wartime interruption of the housing industry left cities ill-prepared for the post-war mass migration of people

residential property.<sup>18</sup> Persons financially unable to own single family city dwellings turned to cooperative apartments, which provided buyers with many features of homeownership at affordable prices.<sup>19</sup> Today, however, the price of most cooperatives limits their use almost exclusively<sup>20</sup> to upper income families.<sup>21</sup>

### A. *The Formation of a Cooperative Housing Corporation*

Modern day cooperative projects can be organized in several ways.<sup>22</sup> Most commonly, however, they are structured through the use of a corporate entity.<sup>23</sup> A promoter initiates the formation of a cooperative

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from rural to urban areas and the influx of returning war veterans. See U.S. DEPT. OF H.U.D., HOUSING IN THE SEVENTIES, A REPORT OF THE NATIONAL HOUSING POLICY REVIEW 10 (1974).

18. For example, in 1940 the average price of a home in an urban area was \$2355. By 1947 the average price had risen to \$5260. See U.S. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES: 1950 720 (71st ed. 1950).

19. See Isaacs, *supra* note 2, at 297-98. The individual purchased a cooperative apartment that provided him with a home in the city. Although the purchaser did not own the entire structure, his purchase gave him the right to inhabit an apartment, at a fraction of the cost of acquiring the whole building. See *supra* note 2 (discussing the home ownership features a cooperative apartment provides).

20. For example, the average price of a cooperative apartment in New York City is \$90,000 per room. This figure is rising. The price per room in 1977 was \$20,000. Johnson, *Great Expectations Fuel New York Area Market*, N.Y. Times, Oct. 28, 1984, § 12 (Magazine), at 34.

21. This Note deals with "expensive" cooperatives financed by the individual purchaser. For an extensive look at government subsidized cooperatives for the lower and middle class, see Note, *The Cooperative Apartment in Government Assisted Low-Middle Income Housing*, 111 U. PA. L. REV. 638 (1962).

22. See Comment, *Restrictions on the Use of Cooperative Apartment Property*, 13 HASTINGS L.J. 357, 358-59 (1961-62). This Note addresses cooperatives organized as corporations. There are, however, two other methods used to organize cooperative housing projects: the "co-ownership method" and the "trust method." Under the co-ownership method, tenants own the building as co-owners in fee simple, with each owner having the exclusive right to occupy an apartment. Co-ownership is accomplished by the use of joint tenancy, tenancy in common, or the California tenancy in common type of ownership. Under the "trust" method, a group of individuals establishes an express trust and transfers title to the building into the trust. A trustee then either hires management or manages the project himself. The trust declaration contains provisions establishing the tenants rights and cooperative project's rules and regulations. See 2 P. ROHAN & M. RESKIN COOPERATIVE HOUSING LAW AND PRACTICE § 2.01[1]-[3], at 2-7 (1984).

23. See McCullough, *supra* note 16, at 309. For an in depth discussion of why corporate cooperatives are favored over other methods of organization, see Yourman, *Some Legal Aspects of Cooperative Housing*, 12 LAW & CONTEMP. PROBS. 126, 127-29 (1947). See also P. ROHAN & M. RESKIN, *supra* note 22, § 2.01, at 2-8.

housing venture.<sup>24</sup> The promoter usually is an entrepreneur who has decided<sup>25</sup> to construct an apartment building or reorganize the ownership features of an existing structure.<sup>26</sup> The corporate entity holds title to the land and building, and is liable on the mortgage.<sup>27</sup> Because states have not enacted legislation governing the formation process,<sup>28</sup> cooperatives generally use the corporate structure to achieve joint ownership between cooperators.<sup>29</sup> Depending on the state, incorporation occurs under either cooperative<sup>30</sup> or general corporate<sup>31</sup> statutes. All states, however, require three legal documents to effectuate a cooperative apartment corporation. These documents are: (1) a corporate charter;<sup>32</sup> (2) a set of corporate bylaws,<sup>33</sup> and (3) a proprietary lease<sup>34</sup> or occupancy agreement. Collectively, these documents set forth both

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24. See 15a AM. JUR. 2d *Condominiums and Cooperative Apartments* § 71 (1964). Promoters are defined as "the person who, for themselves or others, take the preliminary steps towards the organization of a corporation." BLACK'S LAW DICTIONARY 1092 (5th ed. 1979).

25. A promoter may choose to organize a cooperative for a number of reasons. First, if he owns a rental building he may determine he will receive a larger profit by selling the units rather than collecting rent. This usually is the motivating factor in areas having "rent control" laws. For a discussion of rent control, see B. BAIRD, *RENT CONTROL: THE PERENNIAL FOLLY* (1960). Second, the promoter may purchase a building and renovate the structure. Then, by converting the building into cooperative apartments, the promoter can receive a substantial return on his investment. For a detailed discussion of the conversion process, see P. ROHAN & M. RESKIN, *supra* note 22, § 22.01, at 6. Finally, the promoter owning a rental building may no longer want landlord responsibilities.

26. See Bratt, *supra* note 17, at 772.

27. See *infra* notes 59-65 and accompanying text.

28. See P. KEHOE, *COOPERATIVES AND CONDOMINIUMS* 21 (1974). The cooperative formation process, unlike condominium formation, has been left untouched by state legislatures. The various techniques utilized in cooperative formation draw on state trust, property and corporate laws. For an example of state condominium legislation, see FLA. STAT. ANN. § 718, 104 (West 1983).

29. Purchasers receive shares of stock in the cooperative corporation, thus becoming tenant-shareholders, co-owners of the apartment building. See *supra* note 22.

30. Some states have enacted legislation specifically providing for cooperative incorporation. See, e.g., N.Y. COOP. CORP. LAW § 13 (McKinney Supp. 1986).

31. In states that do not have separate cooperative corporation statutes, cooperatives incorporated under general business corporate statutes. See, e.g., CAL. CORP. CODE § 300 (Deering 1977 & Supp. 1985).

32. The corporate charter represents a "contract between the corporation and the state. It defines the rights of its stockholders and is, therefore, in some respects a contract between them individuals." *Aldridge v. Franco Wyoming Oil Co.*, 24 Del. Ch. 153, 158, 7 A.2d 753, 758 (1939).

33. Bylaws are rules a corporation adopts to govern its own management. These

the rules and regulations for building operation and the tenant-shareholders' rights.<sup>35</sup>

Upon formation, the corporation acquires land and an apartment building.<sup>36</sup> Corporate loans secured by mortgages on the acquired land and building provide financing for the acquisition.<sup>37</sup> Once a building is acquired, the corporation allocates stock to various apartments<sup>38</sup> in amounts corresponding to their respective values.<sup>39</sup> Prospective purchasers of individual units subscribe<sup>40</sup> to the corporation's capital stock; each prospective purchaser, however, must also complete an information form before the sale is finalized.<sup>41</sup> This form, along with

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laws regulate the management of the corporation's affairs. See *Bagley v. Reno Oil Co.*, 201 Pa. 56, 57, 50 A.760, 761 (1902).

34. See Goldstein, *Negotiating for a Cooperative Apartment*, 1 REAL ESTATE REVIEW 75, 76-77 (1972). The proprietary lease is defined as a "long term lease and *not* any other kind of ownership document. It is a creature of lawyers' imagination. 'Proprietary' is a descriptive term only, indicating that the tenant is also a shareholder." *Id.* For a discussion of the differences between a proprietary lease and a regular lease, see P. KEHOE, *supra* note 28, at 24.

35. See Note, *Examining Cooperative Conversion: An Analysis of Recent New York Legislation*, 11 FORDHAM URB. L.J. 1089, 1091 (1983). For additional information on corporate charters, bylaws and proprietary leases, see P. KEHOE, *supra* note 28, at 21-24.

36. The landowner transfers to the corporation both deed to the land and title to the building. Title to both, then, vests in the corporation. If no apartment building exists on the land, the corporation must construct one. See *supra* text accompanying notes 25-26.

37. Promoters of cooperating housing projects can utilize a number of methods to finance initial purchase and construction. They can float bond issues, borrow capital from institutional lenders, receive a purchase money mortgage from the seller or simultaneously sell the cooperative interests to tenant-shareholders. See P. ROHAN & M. RESKIN, *supra* note 22, § 2.01, at 2.

38. *Id.* § 2.02[5], at 21. The board of directors determines the amount of shares to which each apartment is entitled. The shares are important because they both give the holder the right to a proprietary lease and determine the amount of the holder's monthly assessment.

39. Note, *supra* note 7, at 1408. An apartment's value is determined by its size, view, location and accessibility.

40. Before a prospective purchaser signs a binding purchase agreement, he "subscribes" to buy cooperative stock. At this point he is called a subscriber. When he is approved by the board and purchases the stock, he becomes a shareholder. See P. ROHAN & M. RESKIN, *supra* note 22, § 2.02[5], at 18. For an example of a subscription agreement, see *id.*, app. D-2, at 223.

41. The form requires a prospective purchaser to give references and information regarding his business and finances. For an example of an information sheet see *id.* at 220-21.

subsequent interviews, is extremely important because it gives the cooperative an opportunity to evaluate the prospective purchaser to determine whether or not he is financially<sup>42</sup> and socially<sup>43</sup> suitable for the community. If the cooperative approves the buyer, he enters into a final agreement<sup>44</sup> for purchase of the stock shares allocated to his apartment.<sup>45</sup> In addition to allowing the tenant-shareholder to purchase stock shares, the purchase agreement grants the buyer the right to enter into a proprietary lease with the corporation.<sup>46</sup> The lease is the essential document of possession without which the buyer may not occupy the apartment.<sup>47</sup>

Having acquired shares of stock and the proprietary lease, the tenant-shareholder becomes obligated to pay a periodic assessment or rent.<sup>48</sup> This assessment constitutes the cooperator's pro rata share of the project's blanket mortgage,<sup>49</sup> interest,<sup>50</sup> capital outlays<sup>51</sup> and operating expenses.<sup>52</sup> The proprietary lease sets forth both the amount and method of payment.<sup>53</sup> The lease also includes "house rules"<sup>54</sup> defining

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42. See *infra* notes 59-65 and accompanying text.

43. See *infra* notes 66-72 and accompanying text.

44. See P. ROHAN & M. RESKIN, *supra* note 22, § 2.02[5], at 18-19. The purchase agreement lists the number of shares to be sold, the sale price and the method of payment. See *e.g., id.*, app. D-2, at 304-10.

45. The buyer is not purchasing an apartment. Rather, he is purchasing shares of stock in the cooperative corporation, entitling him to lease the apartment.

46. See *supra* note 34.

47. Without a proprietary lease, the purchaser has no right to occupy an apartment. Stock ownership, however, is nonetheless important because it gives the purchaser the right to obtain the proprietary lease. See McCullough, *supra* note 16, at 315-16.

48. The term "rent" and "periodic assessment" both signify the amount of money a tenant-shareholder must pay at various intervals. The only difference according to one commentator, is that the term "rent" is considered a sign of inferior social status. See Berger, *Condominium: Shelter on a Statutory Foundation*, 63 COLUM. L. REV. 987, 991 (1963).

49. See Note, *supra* note 7, at 1414. The mortgage reflects the amount of the outstanding loan owed to the seller of the land and building.

50. See Bratt, *supra* note 17, at 773. It is worthwhile to note that the I.R.S. allows a tenant-shareholder to deduct his interest payments on the cooperative's mortgage from his income tax. See I.R.C. § 163 (1985).

51. See Note, *supra* note 5, at 547 (1947). Capital outlays cover such expenses as the building's upkeep, repairs, security and general improvements. The board of directors is responsible for determining this amount.

52. Berger, *supra* note 48, at 991.

53. Some proprietary leases, however, simply leave open the amount of payment due. When payment on the corporation's mortgage is required, each tenant-shareholder

the tenant-shareholder's rights and responsibilities within the cooperative. In addition, both the lease and stock shares contain provisions restricting the cooperator's right to alienate his interest.<sup>55</sup> By entering into the lease, the tenant shareholder implicitly agrees to comply with these rules and restrictions.<sup>56</sup>

### B. *The Need for Restrictions on the Transferability of the Cooperative Apartment*

All cooperative apartment corporations restrict transferability of their dwelling units.<sup>57</sup> The restrictions provide tenant-shareholders with a mechanism for exercising a degree of selectivity in choosing potential cooperative members.<sup>58</sup> Tenant-shareholder control over apartment alienation is essential because of the financial interdependence among tenant-shareholders and the proximity of the dwelling units.

#### 1. Financial Interdependence

The cooperative corporation is subject to a blanket mortgage and a single tax assessment.<sup>59</sup> The cooperative's ability to make timely mort-

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is assessed a pro-rata share based upon the amount of stock he holds. See P. ROHAN & M. RESKIN, *supra* note 22, § 202[5], at 19-21.

54. See Rohan, *Cooperative Housing: An Appraisal of Residential Controls and Enforcement Procedures*, 18 STAN. L. REV. 1323, 1324-25 (1965). These rules vary between cooperative projects. The board of directors is given the power to amend the rules. House rules typically relate to such things as the tenant-shareholders' behavior, music playing and dress in certain building areas. *Id.* at 1325.

55. See Whitebrook, *The Cooperative Apartment*, 9 PRAC. LAW 25, 28-29 (1963). Depending upon how the promoter drafted a particular cooperative's documentation, the restriction may appear solely in the lease or on the face of the stock. Most cooperatives, however, utilize both types of restrictions. See, e.g., Weisner v. 791 Park Ave. Corp., 6 N.Y.2d 426, 160 N.E.2d 720, 190 N.Y.S.2d 70 (1959).

56. See Rohan, *supra* note 54, at 1325. Failure to abide by the house rules may cause the tenant-shareholder to lose his cooperative interest. This occurs when the board exercises the lease's forfeiture provisions. The board may choose instead, however, to file suit and seek injunctive relief.

57. See Isaacs, *supra* note 2, at 219. For a discussion of the different methods a cooperative employs to restrict transferability of dwelling units, see *infra* note 76 and accompanying text.

58. See Moller, *The Condominium Confronts the Rule Against Perpetuities*, 10 N.Y.L.F. 377, 383, 386 (1964).

59. Berger, *supra* note 48, at 993. This is one advantage to owning an interest in a cooperative. Because the entity is liable for the mortgage and tax assessment, the individual tenant-shareholders have limited liability upon default. Co-operators are shielded from the risk of personal liability.



gage payments depends upon each tenant-shareholder's making prompt payment of his monthly assessment.<sup>60</sup> If one cooperator defaults on his obligation, the other shareholders must bear the deficiency.<sup>61</sup> If they fail to pay the difference, a foreclosure proceeding may ensue,<sup>62</sup> resulting in the cooperators losing both their apartments<sup>63</sup> and their equity investments.<sup>64</sup> This financial interdependence between tenant-shareholders necessitates that cooperatives have a method to prevent individuals of limited financial means from acquiring an interest in the project.<sup>65</sup>

## 2. Proximity of the Dwelling Units

In addition to insuring the cooperatives' financial stability, transfer restrictions provide the means to exclude socially undesirable persons.<sup>66</sup> Unlike a conventional homeowner, a cooperative owner cannot

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60. See *supra* notes 48-52 and accompanying text.

61. See P. ROHAN & M. RUSKIN, *supra* note 22, § 2.01[4], at 10. In this situation, each remaining tenant-shareholder would pay part of the unpaid amount on the same pro-rata basis that represents the tenant-shareholder's individual interest in the corporation.

62. See, e.g., *Prudence Co. v. 160 West Seventy-Third Street*, 260 N.Y. 205, 183 N.E. 364 (1932). See also Note, *supra* note 7, at 1410-11. A foreclosure proceeding is initiated by a debtor's failure to make good on his obligation. If the cooperative corporation fails to pay its debt, the creditor will foreclose on the mortgage he has on the land and apartment. The property is then sold, usually in a judicial sale. The balance of the loan is paid from the sale proceeds. For a detailed discussion of foreclosure proceedings, see G. OSBORNE, G. NELSON & D. WHITMAN, *REAL ESTATE FINANCE LAW* § 7, at 424-523 (1979) [hereinafter cited as G. OSBORNE].

63. The cooperator will lose the right to occupy his apartment if he entered into the lease after the mortgage—the cooperative corporation—recorded the mortgage. If, however, his lease began before the mortgage recording, then the cooperator has priority over the foreclosure sale buyer and may remain in his apartment until the lease expires. G. OSBORNE, § 7.12, at 451-52.

64. If the foreclosure sale generates surplus capital, the excess may go to the cooperators. If junior creditors have claims or if the sale fails to raise surplus capital, however, the tenant-shareholders are not reimbursed for previously paid assessments. *Id.* § 7.31, at 519-23.

65. This point cannot be understated. During the Depression years countless cooperative apartment buildings were lost to foreclosure proceedings. "All but two above average-income apartment houses in New York were . . . 'wiped out' during the depression." *Hearings on Cooperative Housing Before the House Committee on Banking and Currency*, 81st Cong., 2d Sess. 222 (1950); Berger, *supra* note 48, at 993 n.35.

66. Note, *supra* note 7, at 1416. What makes a prospective purchaser "undesirable" depends upon the particular views of the cooperative or its board of directors. A prospective purchaser's opinions, tastes or type of employment may be the deciding factor.

isolate himself from his neighbors.<sup>67</sup> Due to the dwelling units' proximity,<sup>68</sup> the joint use of common areas<sup>69</sup> and the inherent necessity for collective action,<sup>70</sup> a tenant-shareholder cannot avoid frequent contact with his neighbors. In order to insure a certain degree of social harmony and agreeable management policies, cooperators must have compatible lifestyles.<sup>71</sup> By restricting the transferability of a tenant-shareholder's interest,<sup>72</sup> cooperatives can prevent disruptive individuals from obtaining the right to inhabit an apartment.

### C. *Transfer Restrictions in the Form of Board of Director Consent Clauses*

An important element, then, of a cooperative housing venture is the ability of tenant-shareholders to select building occupants.<sup>73</sup> Lease restrictions on the right to assign an apartment<sup>74</sup> and transfer restrictions on the sale of corporate stock<sup>75</sup> enable cooperatives to determine who shall occupy the dwelling units. Conditioning all sales and assignments

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67. See Isaacs, *supra* note 2, at 218. "The homeowner can hide from his neighbors . . . . He need have no personal contact with them . . . . The cooperative owner, however, has no place to build a hedge." *Id.*

68. See *supra* note 4.

69. See Moller, *supra* note 58, at 383. Common areas include elevators, halls, swimming pools, recreational facilities and laundry rooms.

70. See Bratt, *supra* note 17, at 774. Tenant-shareholders are called upon to choose board members, vote on management proposals and decide whether to allow a particular purchaser to buy into the project.

71. One court has stated that this is the "only way to keep cooperative housing cooperative." *Gale v. York Center Community Cooperative, Inc.*, 21 Ill. 2d 86, 89, 171 N.E.2d 30, 32 (1960).

72. Cooperatives may never prevent individuals from obtaining the right to occupy an apartment based upon race, religion, creed or sex. For a discussion of this prohibition, see *infra* note 134. See also J. KUSHNER, FAIR HOUSING (1983).

73. See Isaacs, *supra* note 2, at 219.

74. A typical lease restriction provision may read as follows:

The Lessee shall not assign this lease, or any interest therein, and no such assignment shall take effect as against the Lessor for any purpose, unless and until all of the following requirements have been complied with and satisfied:

4. A written consent to such assignment authorized by a resolution of the board of directors . . . must be delivered to the Lessor.

*Weisner v. 791 Park Avenue Corporation*, 6 N.Y.2d 42, 46, 160 N.E.2d 720, 722, 190 N.Y.S.2d 70, 72 (N.Y. 1959).

75. A typical bylaw transfer restriction may read as follows: "No share or shares of the capital stock shall be sold, pledged, encumbered or otherwise disposed of without the prior written consent of the board." See P. ROHAN & M. RESKIN, *supra* note 22, app. D-2, at 203.

of corporate stock on the prior consent of the cooperative's board of directors is the most effective and most commonly employed technique.<sup>76</sup> Because elected tenant-shareholders comprise the board,<sup>77</sup> arguably they are the best qualified to determine whether a prospective purchaser is financially and socially suited to the community.<sup>78</sup>

### III. ATTACKS ON TRANSFER RESTRICTIONS AND THE JUDICIAL RESPONSES

Despite their importance to cooperators, transfer restrictions have not gone unchallenged.<sup>79</sup> Tenant-shareholders who unsuccessfully have attempted to sell<sup>80</sup> cooperative interests have challenged the validity of provisions conditioning sales and assignments of their interests on the board of directors' consent. Judicial response to the attacks clearly has favored upholding the restrictions.<sup>81</sup> Some jurisdictions, however, have acknowledged both the hardships that restrictions place

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76. See *Sanders v. Tropicana*, 31 N.C.App. 276, 278, 229 S.E.2d 304, 307 (1976). "[T]he restraint almost always takes the form of prohibiting transfers except with the consent of the board of directors." *Id.* Cooperatives, however, employ a number of other methods to restrain the transferability of a tenant-shareholder's proprietary lease and stock shares. Among these methods are: (1) requiring the seller to return his interest in exchange for his initial downpayment; (2) requiring the seller to give the corporation the right of first refusal for sale of the lease and stock, at a predetermined or book value price; and (3) requiring the seller to allow the cooperative to meet the purchase price. See *Berger*, *supra* note 48, at 1017. For a brief discussion of the advantages of transfer restrictions, see *Note*, *supra* note 7, at 1418.

77. See *supra* note 7.

78. A cooperator usually resides in the community for a number of years before being elected to a director position. This gives him an opportunity to become acquainted with the other tenant-shareholders and gain a general "feel" of the community's atmosphere, tastes, likes and dislikes. Even so, a director may be isolated from the ideas of the cooperative community at large, or may base his views on those held by his particular social group within the cooperative, rather than on the entire community.

79. See *Note*, *supra* note 7, at 1416. Due to time and expense constraints, and a judicial bias in favor of transfer restrictions, there has not been an overwhelming amount of litigation in this area. See *infra* note 137 and accompanying text.

80. Prospective buyers also have brought suit when boards of directors have refused consent to the proposed sale. See, e.g., *Jones v. O'Connell*, 189 Conn. 648, 458 A.2d 355 (1983).

81. No court has yet declared a cooperative lease or transfer restriction void. See, e.g., *Gale v. New York Center Community Coop. Inc.*, 21 Ill. 2d 86, 171 N.E.2d 30 (1960); *68 Beacon Street, Inc. v. Sohler*, 289 Mass. 354, 194 N.E. 303 (1935); *Sanders v. Tropicana*, 31 N.C. App. 276, 229 S.E.2d 304 (1976).

upon a cooperative-seller<sup>82</sup> and the possibility that the board may abuse its power in withholding consent. As a result, these jurisdictions have formulated and applied a standard that recognizes these concerns; this standard balances the cooperative's needs against the tenant-shareholder's right to sell his interest.<sup>83</sup> Conversely, other courts disregarded a selling cooperator's interests<sup>84</sup> and looked solely to the interests of the remaining tenant-shareholders. These courts give the board of directors unlimited discretion to withhold consent to a sale.<sup>85</sup>

#### A. *Attacking the Validity of Board Decisions to Withhold Consent*

Cooperators opposing board decisions withholding consent have asserted three legal arguments. First, they contend that they have a real property interest in the cooperative, and that restrictions limiting transferability of this interest violate the rule against restraints on alienation. Second, cooperators claim that restrictions on their stock interests violate state corporate laws. Finally, cooperators allege that transfer restrictions on their stock violate the rule against restraints on alienation.

Because an interest in a cooperative corporation gives a tenant-shareholder many attributes of fee simple ownership,<sup>86</sup> cooperators claim that they possess a real property interest.<sup>87</sup> Because a general

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82. These include the inability to liquidate his interest, change residence or change employment.

83. See Bratt, *supra* note 17, at 782-83. The court's focus should be on the restraint's utility as compared to the injurious consequences that would flow inevitably if the restraint were enforced. *Gale*, 21 Ill. 2d at 89, 171 N.E.2d at 33.

84. See, e.g., *Weisner*, 6 N.Y.2d 426, 190 N.Y.S.2d 10, 160 N.E.2d 720.

85. See Whitebrook, *supra* note 55, at 29. By allowing the board of directors to withhold consent to a sale, courts have avoided questions dealing with the legality of withholding consent. The courts will not, however, rubber stamp a board refusal that is based on the buyer's race, religion, creed and sex.

86. See *supra* note 2 and accompanying text. In some situations courts have in fact held that a co-operative interest is an interest in real property. See, e.g., *In re Estate of Pitts*, 218 Cal. 184, 191, 22 P.2d 694, 697 (1933) (ownership of apartment constituted an interest in real property for purposes of estate settlement); *Estate of Rockwell*, 26 Misc. 2d 709, 205 N.Y.S.2d 928 (Sup. Ct. 1960) (cooperative passes through will as real property). *But cf.* *Matter of Miller*, 205 Misc. 770, 772, 130 N.Y.S.2d 295, 296 (Sup. Ct. 1954) (holding that cooperative did not pass to beneficiary although will read "all real estate owned by me"). See P. ROHAN & M. RESKIN, *supra* note 22, § 201[5], at 44. See also Bratt, *supra* note 17, at 782-83.

87. See, e.g., *Jones*, 189 Conn. at 651, 458 A.2d at 357-58. Individuals making this claim must first determine whether or not the jurisdiction characterizes a cooperative interest as one in real property. See Bratt, *supra* note 17, at 784.

rule<sup>88</sup> of real property states that an owner of an absolute estate enjoys an "inherent right to alienate his fee,"<sup>89</sup> cooperators argue that restrictions on the right to transfer cooperative interests are void.<sup>90</sup> Courts take two different approaches when confronted with the issue. Some courts classify a cooperator's interest as a lease.<sup>91</sup> Because restraints on leasehold transferability are universally valid,<sup>92</sup> this characterization allows courts to uphold these restrictions. Other courts, however, avoid labelling a cooperator's legal interest. By simply exempting cooperative housing corporations from the rule against restraints on alienation,<sup>93</sup> these courts compare the policy behind the rule invalidating transfer restrictions<sup>94</sup> with the needs of cooperative projects<sup>95</sup> and conclude that the public policy favoring social and economic stability

88. See Comment, *Restrictions on the Use of Cooperative Apartment Property*, 13 HASTINGS L.J. 357, 362 (1961). A restraint on alienation is defined as:

[A] provision in an instrument of conveyance which prohibits the grantee from selling or transferring the property which is the subject of the conveyance . . . . Any provision in a trust or other instrument which, either by express terms or by implication, purports to prohibit or penalize the use of the power of alienation . . . .

BLACK'S LAW DICTIONARY 1182 (5th ed. 1979).

89. Note, *Due-On-Sale Clauses: An Argument for Adopting the Majority Approach*, 26 WASH. U.J. URB. & CONTEMP. L. 71, 73 (1984). Although courts disfavor restraints on alienation, such restraints nevertheless are upheld if reasonable. See *Tiffany*, *supra* note 1, at § 103. See also Schnebly, *Restraints Upon the Alienation of Legal Interests*, 44 YALE L.J. 961 (1934-35). For a discussion of the rule against restraints on alienation's history and application, see Comment, *supra* note 88, at 361.

90. See, e.g., *Alexy v. Kennedy House, Inc.*, 507 F. Supp. 690, 700-01 (E.D. Pa. 1981) (tenant-shareholder claiming transfer restrictions allowing corporation to buy back apartment at set price constituted illegal restraint on alienation).

91. See *Jones*, 189 Conn. at 650, 458 A.2d at 358. "For some purposes [a cooperative owner] has legal title and an interest in real property, while for other purposes his rights . . . resemble an interest in personal property." *Id.* At least one authority believes that because property rights are statutory creations, state legislatures should determine the nature of cooperative interests. See P. ROHAN & M. RESKIN, *supra* note 22, § 201[5], at 14-15. See also Note, *supra* note 7, at 1417 n.60.

92. See 1 RASCH, LANDLORD AND TENANT 10 (1st ed. 1950). Leasehold rights are not subject to the rule against restraints on alienation. *Id.*

93. See Ross, *Condominium in California—The Verge of an Era*, 36 S. CAL. L. REV. 351, 353 (1962). See, e.g., *Penthouse Properties v. 1158 Fifth Ave.*, 256 A.D. at 691-92, 11 N.Y.S.2d at 423.

94. A number of policy reasons underly the rule. These include the desire to avoid concentration of wealth, restraints tending to prevent property improvement and avoidance of the detrimental effects of keeping property out of commerce. See also Schnebly, *supra* note 89, at 963-64.

95. See *supra* notes 58-73 and accompanying text.

in cooperatives outweighs ritualistic invalidation of restraints on alienation.<sup>96</sup>

Tenant-shareholders claiming that state corporate laws make unlawful and void all restrictions on a shareholder's right to alienate his cooperative stock do not enjoy the support of most<sup>97</sup> state statutes.<sup>98</sup> Most state corporation statutes expressly endorse provisions that restrict a shareholder's right to transfer his shares.<sup>99</sup> Such restrictions are permissible under the theory that a corporation may protect itself from hostile and disinterested persons becoming part of management.<sup>100</sup> Because cooperatives adopt transfer restrictions for reasons similar to conventional business corporations, courts apply these general corporation statutes to cooperative stock as well as corporate stock.

Although courts readily discard complaints focusing on a cooperative's legal interest and on state corporate statutes, judicial scrutiny increases in most jurisdictions when a cooperator contends that stock transfer restrictions constitute unlawful restraints on alienation.<sup>101</sup>

A majority of jurisdictions do not allow a cooperative's board of directors full and arbitrary power to withhold consent to stock trans-

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96. See Moller, *supra* note 58, at 386.

97. See, e.g., *Beacon Street, Inc. v. Sohior*, 289 Mass. 354, 357, 194 N.E. 303, 306 (1935).

98. The tenant-shareholders' position is adopted by a few states. The statute of one such state, New Hampshire, reads: "No corporation shall make any bylaw to restrain the free sale of its stock; every such bylaw shall be void." N.H. REV. STAT. ANN. § 296:14 (1977).

The overwhelming majority of jurisdictions, however, do not follow the New Hampshire model. Even in those states that have not enacted a statute allowing bylaw transfer restrictions, courts have upheld "reasonable restrictions." See 8 FLETCHER, CYCLOPEDIA CORPORATIONS § 4205 (Perm. ed. 1932). For an example of a case adopting this position, see *Ling & Co. v. Trinity Sav. & Loan Ass'n.*, 482 S.W.2d 841 (1972) (reasonable restriction on alienation of stock valid under Texas general corporate statute).

99. A typical statute reads as follows: "[R]estrictions on the right to transfer shares . . . shall be set forth on the certificate." OHIO REV. CODE ANN. § 1701.25 (Page 1985).

100. See FLETCHER, *supra* note 98, § 5461, at 228-309.

101. See, e.g., *Beacon Street, Inc. v. Sohior*, 284 Mass. 354, 194 N.E. 303 (1935) (contending that transfer restrictions on back of stock constitute illegal restraint); *Penthouse Properties v. 1158 Fifth Ave.*, 256 A.D. 685, 11 N.Y.S.2d 417 (contending that a board of directors' refusal to transfer stock shares on corporation's books, pursuant to transfer restriction, constituted illegal restraint).

fers.<sup>102</sup> These jurisdictions attempt to balance the cooperator's desire to freely dispose of his property against the competing need of the cooperative to protect its members' social and financial security.<sup>103</sup> In so doing, these courts neither declare consent clauses "automatically void nor automatically valid."<sup>104</sup>

This majority view generally upholds unequivocally stated consent clauses if the clauses protect the cooperative's social and financial welfare.<sup>105</sup> To determine whether the board has acted reasonably in withholding consent,<sup>106</sup> these courts review, on a case by case basis, the decisions made by a cooperative's board of directors. The Connecticut Supreme Court adopted this position in *Jones v. O'Connell*.<sup>107</sup>

In *Jones*, a cooperator in a six-unit cooperative apartment project contracted to sell her stock shares to another tenant-shareholder, Jones,<sup>108</sup> who owned the apartment directly below. Jones planned to combine the apartments to provide additional living space for his family.<sup>109</sup> Provisions in the proprietary leases and memoranda of offerings conditioned the sale of each tenant-shareholder's stock on board ap-

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102. See, e.g., *Mowatt v. 1540 Lake Shore Drive Corp.*, 385 F.2d 135, 137 (7th Cir. 1967) (holding absolute control unjustified).

103. See *id.* at 137. "[T]he freedom of each member-tenant to dispose of his property right should be afforded protection . . . the power to withhold consent must be exercised in the light of the purpose of the arrangement." *Id.* See also *Bratt*, *supra* note 17, at 785.

104. *Jones v. O'Connell*, 189 Conn. at 654, 458 A.2d at 358. The courts employ a balancing test. See *supra* note 83 and accompanying text.

105. *Jones*, 189 Conn. at 654, 458 A.2d at 358. Restrictions must be stated clearly and conspicuously. The failure to do so may prevent a restriction from binding a tenant-shareholder for lack of notice, vagueness or the general inclination of courts to void restraints on fee interests. "[T]he law does not favor . . . and will not recognize them unless stated in unequivocal terms." *Id.* But see *Sanders v. Tropicana*, 31 N.C. App. at 284, 229 S.E.2d at 309 (restrictions must be stated clearly, but they do not have to "detail every instance" when consent will be withheld).

106. See Comment, *supra* note 88 at 360-62. Courts apply a two-pronged test. The first prong entails determining whether the transfer restriction was enacted to protect the tenant-shareholder's social and financial interests. If a court determines that the first prong is met, then it next must determine whether the board acted reasonably when exercising the restriction. See, e.g., *Mowatt*, 385 F.2d 135.

107. 189 Conn. 648, 458 A.2d 355 (1983).

108. See *id.* at 651, 458 A.2d at 357. The contract also included assignment of the seller's proprietary lease.

109. *Id.* The plaintiff remarried the year before and had two additional children living with him. By purchasing the rights to occupy the apartment, the plaintiff planned to house his larger family in the two separate apartments.

proval.<sup>110</sup> After the board refused to approve the proposed sale, Jones brought suit to enjoin its decision.<sup>111</sup> Jones maintained that the board unreasonably withheld consent to the sale.<sup>112</sup> He further alleged that the stock restriction constituted an unlawful restraint on the alienation of property.<sup>113</sup> Responding to Jones' allegations, the board of directors justified its decision to withhold consent by asserting its desire to protect the other tenant-shareholders' interests in the cooperative.<sup>114</sup>

The board claimed that the proposed sale would ruin the cooperative's character. The board also maintained that Jones' intended use of the apartments would interfere with the other cooperators' use of the common stairway<sup>115</sup> and might depreciate the apartments' market value.

The court accepted the board's rationale and upheld its decision.<sup>116</sup> The court based its holding on the fact that the cooperative enacted the restrictions to protect the interests of its tenant-shareholders.<sup>117</sup> It held that the board's decision was reasonable in light of the structural problems associated with Jones' intended use of the apartments.<sup>118</sup> Although the court upheld the board's decision, its analysis illustrates the majority view's willingness to review board decisions and prevent a board from exercising unfettered discretion in withholding consent to

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110. *Id.* The memorandum of offering and the proprietary lease contained different standards governing a board of directors' withholding of consent to transfer of a tenant-shareholder interest. The memorandum gave the board the power to reject individuals of unsuitable "character and financial responsibility." *Id.* The proprietary lease, however, indicated that "consent . . . can be granted or withheld for 'any reason or for no reason.'" *Id.* In light of its reluctance to enforce restraints on alienation, the court concluded that "the limited clause in the memorandum of offering must prevail over the unqualified consent clause in the proprietary lease." *Id.* at 655, 458 A.2d at 359.

111. *Id.* at 651-52, 458 A.2d at 356.

112. *Id.* at 652, 458 A.2d at 357.

113. *Id.*

114. *Id.* at 656, 458 A.2d at 359. The board of directors asserted that because the two apartments were not connected and the only access between them was the common stairway, a single family occupying both apartments would cause great inconvenience to the other tenant-shareholders. *Id.*

115. This combined use of the two apartments would make the stairway a part of the two affected apartments in such a way as to interfere with its common use by other tenants, who had an interest in the preservation of the building as a cooperative with six separate apartments. *Id.* at 657, 458 A.2d at 360.

116. *Id.* at 652, 458 A.2d at 356.

117. *Id.* at 656-57, 458 A.2d at 359-60.

118. *Id.*



the sale of a cooperative apartment.<sup>119</sup>

Representing the opposing view, New York courts hold that, because of the special economic and social features unique to cooperative ownership,<sup>120</sup> transfer restrictions on cooperative stock do not violate the rule against restraints on alienation.<sup>121</sup> This position is based upon the theory that a cooperative's members have an unconditional right to select their neighbors.<sup>122</sup> Not only do the courts uphold the restrictions but they also refuse to review board decisions denying consent,<sup>123</sup> regardless of how arbitrary or unreasonable denials may seem.<sup>124</sup>

The New York rule originated in *Weisner v. 791 Park Avenue Corp.*<sup>125</sup> In *Weisner*, a tenant-shareholder contracted to sell his cooperative interest.<sup>126</sup> The cooperative corporation's bylaws contained transfer restrictions conditioning all sales or assignments of corporate stock upon approval of the board of directors.<sup>127</sup> After reviewing the buyer's application, the board summarily refused to consent to the proposed sale.<sup>128</sup> Asserting that the board unjustly had withheld consent because certain board members had a personal vendetta against him,<sup>129</sup>

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119. See *supra* notes 102-04 and accompanying text.

120. See *Penthouse Properties*, 265 A.D. at 692, 11 N.Y.S.2d at 423, "We conclude . . . that the special nature of the ownership of co-operative apartment houses . . . requires that they not be included in the general rule against restraint on the sale of stock in corporations organized for profit." *Id.*

121. To date, only New York has adopted this approach. Cooperative apartments, however, are spreading to other jurisdictions. Whether these jurisdictions will follow the New York or the majority view remains to be seen.

122. See *Weisner*, 6 N.Y.2d at 434, 160 N.E.2d at 724, 190 N.Y.S.2d at 75. "[T]here is no reason why the owners of a cooperative apartment house could not decide . . . with whom they wish to share . . . their home." *Id.*

123. Absent a claim of illegal discrimination these courts will dismiss the complaints for failure to state a claim. See *id.* at 434, 160 N.E.2d at 724, 190 N.Y.S.2d at 76.

124. See *Goldstone v. Constable*, 84 A.D.2d 510, 511, 443 N.Y.S.2d 380, 381 (1981). "The directors of this cooperative housing corporation have the contractual and inherent power to approve or disapprove the transfer of shares and the assignment of proprietary leases." *Id.* See also 15a AM. JUR. 2d § 82 (1976). Individuals denied admittance because of owning animals or washing machines are examples of unreasonable denials. See Rohan, *supra* note 55, at 1332.

125. 6 N.Y.2d 426, 160 N.E.2d 720, 190 N.Y.S.2d 70 (1959).

126. *Id.* at 430, 160 N.E.2d at 721-22, 190 N.Y.S.2d at 72.

127. *Id.* at 431, 160 N.E.2d at 722, 190 N.Y.S.2d at 73.

128. *Id.* at 433, 160 N.E.2d at 723, 190 N.Y.S.2d at 75.

129. Weisner claimed that the cooperative corporation's treasurer and board members harbored animosity towards his brother. *Weisner v. 791 Park Ave. Corp.*, 7 A.D.

Weisner sued the board of directors seeking specific performance of the sales contract.<sup>130</sup> The New York Supreme Court, special term, dismissed the complaint by denying Weisner's motion for a temporary injunction.<sup>131</sup> On appeal the New York Supreme Court, Appellate Division, reversed the special term court, granting buyer's claim for specific performance.<sup>132</sup> Subsequently, the New York Court of Appeals reversed the appellate division's decision,<sup>133</sup> concluding that absent a claim of discrimination based upon race, religion or sex, "there was no reason why the owners of a cooperative could not decide for themselves with whom they wished to live."<sup>134</sup>

#### IV. AN ANALYSIS OF THE NEW YORK AND MAJORITY POSITIONS AND AN ALTERNATIVE PROPOSAL

##### A. *The New York View*

Courts adhering to the New York rule accomplish their goal of protecting cooperators from potential financial or socially disruptive influences. By refusing to review board decisions denying prospective purchasers admittance into the cooperative, these courts give cooperative owners a unique opportunity to construct and preserve a commu-

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75, 78, 180 N.Y.S.2d 734, 737 (1958), *rev'd*, 6 N.Y.2d 426, 160 N.E.2d 720, 190 N.Y.S.2d 70 (1959). *See also* Note, *Cooperative Apartments—A Legal Hybrid*, 13 U. FLA. L. REV. 123, 130 (1960).

130. *Weisner*, 7 A.D.2d at 78, 180 N.Y.S.2d at 737.

131. *Weisner v. 791 Park Ave. Corp.*, 177 N.Y.S.2d 887, *rev'd*, 7 A.D. 75, 180 N.Y.S.2d 734 (1958), *rev'd*, 6 N.Y.2d 426, 160 N.E.2d 720, 190 N.Y.S.2d 70 (1959).

132. *Weisner*, 7 A.D.2d at 83, 180 N.Y.S.2d at 742 (appellate division held that consent cannot be denied arbitrarily).

133. 6 N.Y.2d at 434, 160 N.E.2d at 724, 190 N.Y.S.2d at 75. The New York Court of Appeals stated:

The statute which prohibits discrimination in cooperative because of race, color, religion, national origin or ancestry is not involved in this case. Absent the application of these statutory standards, and under the terms of the agreement between plaintiff and Gilbert, there is no reason why the owners of the co-operative apartment house could not decide for themselves with whom they wish to share their elevators, their common halls and facilities, their stockholders' meetings, their management problems and responsibilities and their homes.

*Id.*

134. The Fair Housing Act makes it "unlawful to refuse to sell . . . or make unavailable or deny, a dwelling because of race, religion, sex or national origin." Title VIII of the Civil Rights Act of 1968, 42 U.S.C. § 3604(a)(1962). State legislators have also enacted civil rights laws making housing discrimination illegal. *See, e.g.*, N.Y. CTY. RIGHTS LAW § 19-a(1) (McKinney 1976). *See also* P. ROHAN & M. RESKIN, *supra* note 22, § 7.02[2][a].

nity of individuals with similar tastes, ideals, and standards of living. Despite these benefits, the New York approach fails as a model position for several reasons. First, permitting a board of directors to exercise absolute unreviewable discretion, provides cooperatives with the means to practice unlawful discrimination.<sup>135</sup> New York's minority approach enables a board of directors to conceal discrimination based on race, religion and national origin<sup>136</sup> when considering prospective buyers, even though the courts would invalidate such discrimination if evident. A board's ability to invent justifications for labeling a buyer "undesirable," when combined with the minority view's unyielding deference to board decisions, effectively shields a cooperative practicing discrimination. The difficulty and expense inherent in pursuing such allegations in court may further discourage attempts to challenge board denials.<sup>137</sup>

Another problem with the New York approach is that, by providing boards of directors with such broad powers, courts supply a method by which cooperatives can "lock" tenant-shareholders into the project. Because courts allow a board to arbitrarily and unreasonably<sup>138</sup> reject any sale, a cooperator often lacks legal recourse to liquidate his investment. For many shareholders, the inability to sell makes it impossible to relocate or to accept an employment transfer. Taken to the extreme, refusing to approve a sale could force a cooperator into insolvency.<sup>139</sup> The inequity of these problems is magnified in cases where a board withholds consent to economically sound purchasers solely because they fail to meet particular social standards.

A final flaw in the New York approach is the possibility that the rule prevents financially able persons from acquiring quality housing. Public policy dictates that when housing is available, individuals of suffi-

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135. See, e.g., *Robinson v. 12 Lofts Realty, Inc.* 610 F.2d 1032 (2d Cir. 1979).

136. See *United States v. City of Black Jack*, 508 F.2d 1179 (8th Cir. 1974). "[C]lever men may easily conceal their motivations." *Id.* at 1186.

137. Aside from the enormous legal expenses litigation would cause, the potential litigant also must consider practical matters. If preliminary injunctive relief is denied, the rejected purchaser must find substitute housing. If the suit eventually is tried successfully, the plaintiff must ask himself whether it is worth moving again and whether he wants to live in a cooperative whose members are hostile to him.

138. See *supra* note 120-24 and accompanying text.

139. For example, if a tenant-shareholder has outstanding debts, he might choose to sell his apartment. In such a situation, the board of directors' refusal to consent to the proposed sale may lead the cooperator to declare bankruptcy. This result would also hurt the other cooperators who would have to assume the bankrupt cooperator's payments.

cient financial means should not be denied access merely because they fail to meet certain social standards.<sup>140</sup> Adherence to this policy is especially appropriate in urban areas where shortages of quality housing are common.<sup>141</sup> Individuals denied access to cooperatives are forced to compromise their living expectations by residing in less desirable areas, or by residing in the suburbs and commuting. While these hardships are often inescapable when housing is unavailable, it is unjust to force them upon individuals capable of affording a cooperative apartment. Thus, while the New York approach may serve a useful purpose, the undue hardships caused by its overly broad and mechanical application far outweigh its usefulness.

### B. *The Majority*

In contrast to the New York approach, the majority approach preserves the cooperative's social and financial integrity and, at the same time, protects the tenant-shareholders' rights to liquidate their interests.<sup>142</sup> The majority deviates from the New York approach in that it believes that cooperators have the right to alienate their cooperative interests provided that the consequences are not detrimental to other cooperators. The majority standard for determining whether or not a board has acted unlawfully prevents unjust or arbitrary denials of consent. Concurrently, the standard protects the remaining tenant-shareholders by leaving intact the board's power to reject risky purchasers. The majority view further safeguards tenant-shareholders' interests by placing the burden upon the board to show that its decision is reasonable. This procedural difference limits the likelihood that the board will deny a cooperator the full value of his investments while leaving the board sufficient discretion to enable it to adequately protect the remaining tenant-shareholders.

In addition to being more equitable, the majority position also serves the public welfare. By guaranteeing the right to sell a cooperative in-

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140. See Rohan, *supra* note 54, at 1332. "[W]here benefit to the group interest allegedly served is remote and speculative and harm to the individual is real and immediate . . . the cooperative may best be served by holding the regulation unreasonable." *Id.*

141. High rents and limited space characterize the housing market in city areas. Purchasing a cooperative apartment rather than paying high rents thus makes practical sense. If the cooperative assessment and the apartment rent are similar, a buyer who purchases a cooperative builds up an equity investment and has the additional advantage of deducting his mortgage interest payments.

142. See *supra* note 103.

vestment, the majority makes cooperatives an attractive form of home ownership. As the demand for cooperative apartments increases, developers convert more buildings from rental units to cooperatives. Because the cooperative apartment is a tenant-shareholder's home as well as an investment, he invests more capital into its renovation and upkeep. This will result in the improvement and regeneration of urban neighborhoods.<sup>143</sup> Such development will inevitably cause a general increase in the quality of city life.

Practical problems, however, arise in the application of the majority approach. By merely placing a reasonableness standard upon board decisions, the majority gives boards of directors and selling cooperators little guidance for determining what factors a board may properly consider. Furthermore, reasonableness standards may vary from one jurisdiction to the next. For example, one court has held that the extensive use of stairs by a family is a reasonable justification for the board to withhold consent.<sup>144</sup> The same reason in another jurisdiction, however, may be unsatisfactory. The absence of a clear and uniform standard of review has compelled litigators to bring suits on an ad hoc basis. These ad hoc suits are both costly and inefficient.<sup>145</sup>

While the majority approach limits the board of directors' power to prevent tenant-shareholders from selling their stock, two factors suggest that the approach does not go far enough. First, the shortage of quality city housing and the interrelated financial interests of tenant-shareholders warrant that cooperatives admit persons of sufficient financial ability. A public policy of ensuring individuals access to housing within their means arguably is preferable to a policy of permitting cooperatives to restrict entry only to individuals meeting certain social criteria.

Second, it is questionable whether as a matter of policy, courts

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143. See U.S. DEPT. OF H.U.D., *THE CONVERSION OF RENTAL HOUSING TO CONDOMINIUMS AND COOPERATIVES* 231 (1980) ("Policy favoring cooperative ownership as a means of upgrading urban housing."); P. ROHAN & M. RESKIN, *supra* note 22, § 201[5], at 19. If a restriction prohibits a cooperator from selling his interest without first obtaining the board of directors' prior consent, the board retains an "absolute restraint." These restraints "prevent improvement upon land, because landowners are reluctant to make improvements on property they cannot sell. Therefore, the restraint retards the development of the community." Schnebly, *supra* note 89, at 964.

144. *Jones v. O'Connell*, 189 Conn. 548, 458 A.2d 355 (1983). See also *supra* notes 114-15 and accompanying text.

145. See Note, *supra* note 89, at 97. Attorney fees are expensive, court dockets are crowded, and the chances of successful litigation are doubtful. See also *supra* note 137.

should ever allow a cooperative to reject a prospective purchaser based upon social considerations. A free society should neither encourage nor enhance a group's effort to maintain "pure" communities, when a consequence of that effort is to prevent some individuals from obtaining the housing of their choice and prevent others from selling a dwelling they no longer desire to keep. Even in light of this well-reasoned argument, however, majority courts continue to uphold board decisions to withhold consent.<sup>146</sup>

### C. *An Alternative Proposal*

As the preceding discussion indicates, both the New York and majority positions present problems. An analysis of the two reveals that a tenant-shareholder's right to liquidate his cooperative interest requires more attention and protection. Because of the political strength of cooperative housing groups and the internal nature of membership restrictions, it is doubtful whether state legislature will address these concerns.<sup>147</sup> The responsibility to vindicate cooperators' rights, therefore, lies with the judiciary.

Courts can provide protection for both the tenant-shareholder and the remaining cooperators by limiting a board's power to withhold consent<sup>148</sup> to those cases in which the purchasers financial stability is in question. This insures a cooperator's ability to liquidate his investment while protecting the remaining tenant-shareholders from financial ruin.<sup>149</sup> This standard denies cooperatives the power to reject a

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146. See Rohan, *supra* note 54, at 1326. "[T]he board can make, interpret, and selectively enforce restrictions with little danger of being reversed by the courts." *Id.*

147. State legislators have been extremely reluctant to pass cooperative legislation. "As early as 1928 the call for legislative clarification of co-operators' rights went out" but has since received little response. P. ROHAN & M. RESKIN, *supra* note 22, § 2.01[5], at 15.

148. One expert is of the opinion that if accepting a particular purchaser would cause a great hardship on the other tenant-shareholders, the board of directors should, after a proper hearing, have the power to reject him. Such a situation arose when former President Richard M. Nixon attempted to purchase a cooperative in New York City. He made it clear, however, that precautions such as television monitors, elevator guards and body searches of all individuals entering the cooperative would be necessary. The board refused to consent to the sale and Nixon brought suit. The suit eventually was dropped. Interview with John N. Drobak, Professor of Law, Washington University School of Law, in St. Louis, Missouri (Feb. 2, 1985).

149. Financially risky purchasers always can be rejected by a board of directors. The board of directors should not, however, be the financial judge. This decision should be made by an independent accounting firm, approved by both parties, which is given the necessary statements and figures. This approach insures an objective analysis.

buyer based upon arbitrary social considerations. To protect the remaining tenant-shareholders' social concerns and prevent them from being laden with disruptive and inconsiderate purchasers, however, cooperatives should insert into the project's bylaws strict house rules. The cooperative then can condition a purchaser's continued right of occupancy upon compliance with the rules.<sup>150</sup> Because courts will enforce house rules,<sup>151</sup> cooperatives, through precise drafting, can maintain harmonious communities.

Cooperatives should, however, be wary of board members unjustly exercising these forfeiture provisions for violations of the house rules.<sup>152</sup> To guard against such abuse and curtail legal expenses, cooperatives can insert arbitration clauses into their documentation. These clauses would require cooperatives and tenant-shareholders to submit disputes to an independent arbitration committee instead of filing suit.<sup>153</sup> Arbitration would benefit the cooperative by reducing litigation costs. Additionally, arbitration benefits tenant-shareholders by providing them with an independent forum to have their grievances heard.

#### IV. CONCLUSION

The cooperative's need to restrict dwelling unit transferability cannot be understated. Without this ability a major and important source of modern day housing would perish. Similarly, an individual's ability to liquidate his cooperative interest is an important right that deserves protection. In the future, courts called upon to determine the validity of stock transfer restrictions should adopt a more practical approach, recognizing both the needs of selling cooperators and the remaining tenant-shareholders. By limiting the reasons for which a board of directors can reject a sale, the courts can provide cooperators with a greater opportunity to sell their cooperative interests. Furthermore, cooperatives can still protect remaining tenant-shareholders from in-

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150. See *supra* notes 55-56 and accompanying text.

151. See *Rohan*, *supra* note 54, at 1335. "Where public policy is not contravened . . . a promoter may insert the most restrictive house rules imaginable in a project's . . . documentation." *Id.*

152. See Note, *supra* note 5, at 608-10. Because a board can adopt and interpret house rules and forfeiture provisions, it has the power to "target" a particular co-operator for unjust eviction. The courts should, therefore, be wary of cooperatives unjustly exercising forfeiture provisions for house rules violations.

153. The arbitrator can be a member of an arbitration association or may be an appointed arbitrator, such as a law professor.

corrigible purchasers by conditioning the purchaser's right of occupancy upon stringent house rules.