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The Tyranny of the Majority in Small Co-ops

How Are Minority Interests Protected?

Darryl M. Vernon

When someone buys 25% of a four-unit co-op, does the shareholder expect the co-op to be ruled by only one other shareholder, which could be the case if one of those four shareholders owns more than 50% of the co-op's shares? The issue arose in a recent case currently on appeal to the Appellate Division First Department. *Akasa Holdings v. Sweet*, No. 65011-12, slip. op. (Sup. Ct., N.Y. Cty 2012, Kornreich, J.). (*Crosby* case).

Within small co-ops, the primary protection against the must come from the co-op's governing documents. Those documents typically only include by-laws, articles of incorporation and a proprietary lease. But as became readily apparent in the *Crosby* case, a shareholders' agreement is a crucial document and should be carefully written to reflect shareholder intentions.

THE FACTS OF THE CROSBY CASE

The plaintiff in *Crosby* was one of four shareholders and proprietary lessees in a co-op, but the plaintiff owned 50.8% of the shares. The primary question before the court was whether plaintiff could obtain board representation commensurate with share ownership. Although the court had three documents to consider — 1) the by-laws; 2) the propriety lease; and 3) a shareholders' agreement — the crucial clause was in the Shareholders' Agreement. It provided:

The Shareholders agree to cause the nomination for election and to vote their Shares for the election of each Shareholder (or any designee residing in the New York Metropolitan Area of any such Shareholder) as a director of the Corporation, as long as each of them is a Shareholder of the Corporation.

For roughly a decade, the unit owners (including plaintiff's predecessor) followed this provision of the Shareholders' Agreement by electing one board member per unit. But, shortly before plaintiff purchased, there was a shareholder meeting at which a majority of the shareholders (which plaintiff's unit could accomplish

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Small Co-ops

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alone, owning more than 50%) voted to increase the number of board members to five, and to allow plaintiff's predecessor to have two seats on that new five-member board.

The validity and effect of the meeting was challenged by the defendants. But that issue was deftly avoided by the court just deciding how the governing documents should apply to voting. The plaintiff stated that when it purchased the unit it expected that the voting would proceed with a five-member board, with plaintiff having two members as its predecessor (from whom it purchased) had for its board representation. Essentially, plaintiff argued that two out of five on the board still did not give the plaintiff a majority of the board, but since it held over 50% of the shares and paid over 50% toward the costs of running the co-op, at least it should have some extra voting power on the board.

The defendants argued that the Shareholders' Agreement was designed to ensure that no one unit would have more voting power than another unit as it concerned board decisions. This was particularly important given that the plaintiff held over 50% of the shares, and thus, in most instances, would control when it came to shareholder voting. Defendants reasoned that it should be obvious that to own a unit in a co-op where one unit owner can control both the board and shareholder decisions would significantly diminish the value of such a minority unit.

Affidavits were submitted showing that equal say on the board was a significant factor in purchasing a minority interest in this small co-op. On the flip side, if plaintiff were to manage to be able to vote beyond what the Shareholder Agreement

Darryl Vernon, a member of this newsletter's Board of Editors, practices at Vernon & Ginsburg, LLP, and represents the minority shareholders in the *Crosby* case.

provided, the value of the plaintiff's unit would accordingly increase.

The by-law provision concerning the number of directors said that the number of directors "shall be three, or such other number, no more than seven or less than three, as may be from time to time provided herein." That number could only be changed "by resolution of the shareholders from time to time at any annual or special meeting." Plaintiff argued that, in light of this provision, by a simple majority shareholder vote the number of members of the board could be changed to five, and that could be accomplished by plaintiff alone since plaintiff owned more than 50% of the shares.

Defendants relied on the Shareholders' Agreement, which provided that the shareholders "agree to cause the nomination for election and to vote their Shares for the election for each Shareholder ... as a director of the [Co-Op], as long as each of them is a Shareholder of the [Co-Op]." Defendants argued that the board members had, for a decade, reasonably interpreted this provision to require each shareholder to vote for every other shareholder as a director, and to preclude any non-shareholder directors. Defendants explained that the by-law provision for a range of directors was common, and in this case reflected that there were initially only three shareholders, and the possibility, contemplated by the Shareholders' Agreement, that the plaintiff's unit (which was comprised of two floors), could be split into two units. If that occurred, the board could go to five members, as there would then be five different shareholders

THE COURT'S DECISION

The court had to decide how the by-laws and Shareholders' Agreement would be applied, and reconciled, in light of the parties' dispute about the number of board members. At an earlier stage of the litigation, the court had said:

The by-laws are trumped, according to the by-laws and the

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proprietary lease, by the proprietary lease. So if there is a conflict between the by-laws and proprietary lease, the proprietary lease controls. And reading the shareholders' agreement, if there is a conflict between the proprietary lease and the shareholders' agreement, the shareholders' agreement controls. So what it is, is the bylaws on the bottom, trumped by the proprietary lease, trumped by the shareholders' agreement. And that's the way this whole thing works.

Defendants urged that this was pivotal as the Shareholders' Agreement spelled out how the nomination and election were to occur. The by-laws could not change the voting procedure in the Shareholders' Agreement. If the by-laws did that, then they would be trumping the Shareholders' Agreement.

The court, however, found that the by-laws and Shareholders' Agreement could be "read together" to "clearly set forth the following procedure for determining the size of the board and electing directors":

(1) Pursuant to Article III, Section 1 of the By-Laws, the shareholders are to vote on a number, between three and seven, of directors to serve on the Board; (2) pursuant to §5.1.3 of the Shareholders' Agreement, the Shareholders are to nominate candidates to serve as directors on the board; and 3) pursuant to section 5.1.3 of the Shareholder Agreement, the shareholders are to vote on each of the nominees.

THE APPEAL

The defendants appealed from the court's resolution of the board issue. (Plaintiffs appealed from a portion of the court's opinion rejecting their argument that the other shareholders had improperly appropriated space outside their units). Defendants' position is that the above quote from the court does not accurately track the language of the Shareholders' Agreement. Section 5.1.3 does not say that the shareholders are to nominate "candidates" to serve as directors. It says that the shareholders will nominate each shareholder. It does not provide for strangers, essentially, to be candidates. Moreover, section 5.1.3

does not say, as the court suggested, that the shareholders are to "vote on each of the nominees." Instead, the Agreement provides that the shareholders are to cause the election of each of them as directors.

If the Shareholders' Agreement is read as the defendants urge, the Shareholders' Agreement would trump any provision in the by-laws authorizing a majority of shareholders to increase the number of directors. The Shareholders' Agreement stated it could not be modified except by a unanimous vote of the shareholders, a provision designed to protect the interest of minority shareholders in a small co-op.

CONCLUSION

At press time, the case was scheduled to be heard soon. The issues that will be heard are how a shareholders' agreement should be construed in a small co-op. Defendants planned to argue that plaintiff's reading of the bylaws and Shareholders' agreement undermines the protection that a shareholder agreement needs to provide in a small co-op to protect against a tyranny of the majority.

