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Fear of Rejection

Protect Your Board From Discrimination Suits

By Diane Frost

More than 100 board members, residents, and guests recently gathered to hear a workshop seminar on how boards can avoid discriminatory practices when approving applications from prospective purchasers. The seminar panels were held in conjunction with The Cooperator's 15th Annual Co-op and Condo Expo February 25 at the New York Hilton.

"Denied! Avoid Discrimination Against Prospective Purchasers" featuring expert panelists, Eric P. Gonchar and David Rothfeld of Kane Kessler, P.C.; Steven Birbach of Carlton Management; Mary Lesnewski of The Whitmore Group, and Peter B. Marra of William B. May; examined the legal rights that boards have in reviewing a prospective applicant and what the current federal, state, and local law requires when those decisions are made.

"One thing that you should know is that there is more and more case law regarding discrimination in co-op transactions becoming available each day," Gonchar stated. "The courts in New York are becoming much more lenient to hear these cases and they will review and hold co-op boards accountable for improperly made decisions. As board members I urge you to take heed." Any board action must be made in good faith, he added, but the burden of proving discrimination falls squarely on the shoulders of the applicant or shareholder. Discrimination claims, Gonchar said, most often affect co-ops because applicants must go through an approval process. "A co-op can use the scrutiny of reviewing co-op board applications as a way to protect a shareholder from those that do not fit the financial and the social profile of the building."

The Legal Pitfalls

Before you make up your mind about a prospective resident however, it's important to know upon what you can and cannot lawfully base your decision. According to Rothfeld, federal, state, and city laws all prohibit discrimination, and violators may face hefty fines. If found liable, compensatory and punitive damages might be awarded by a court in an amount that could easily exceed $100,000, he said.

What you can get sued for is pretty straightforward. As described in the Fair Housing Act, Title VIII of 1968, it is "...Unlawful to discriminate in matters of rent or sale or financing of a residential dwelling based on race, age, color, religion, sex, or national origin," as well as to advertise for specific family status or refuse to accommodate people with disabilities. A clause covering familial status was added in 1988, and according to Mayglothling, "You also can't ask [about] marital status or sexual orientation."

Not all discrimination is criminal, however; technically, "discrimination" is nothing more than the criteria a group sets for itself by which it screens new members. There are plenty of legitimate reasons for turning a prospective buyer away. Things like insufficient income, overseas or out-of-state assets that make collecting arrears difficult, an unfavorable credit history, a history of perpetual litigation, fraudulent application information, high-maintenance celebrities, use of the apartment strictly as an investment, or a just plain unlikable demeanor are all perfectly sound reasons for rejection.

In fact, one of the most common reasons for denial, asserted Gonchar, are financial considerations or an improper application. "It's important for the purchaser to fill out an application completely and accurately so the board can make a determination whether or not they fit the financial profile of the building. So many turndowns are actually due to the fact that the application was incomplete or not accurately completed."

The Agent's Role

The legal leapfrogging begins with a call from a potential buyer to a co-op's managing agent, requesting an application. According to Steven Wagner, partner with the Manhattan law firm of Wagner, Davis, & Gold, PC, the application package includes all the information a manager needs to conduct a thorough investigation of the applicant: credit history, the buyer's last tax return, six months of financial activity documents, assets and liabilities, a recommendation from the buyer's present and immediately prior landlords, recommendations from both colleagues and personal contacts, a copy of the contract of purchase, criminal background checks, the buyer's social security number, and–once all the information has been examined–a positive or negative recommendation from the managing agent.

After all the legwork, however, it's still the board that has the final say, according to Ian Mayglothling, transfer department supervisor for Manhattan's Midboro Management, Inc. "The managing agent's role is limited," he says. "We'll receive applications to purchase and make sure of their completeness–that there are no gaping holes. We guide the board and offer advice from our experience, if they ask. But we don't say 'accept A, deny B.' It's not that cut-and-dry. They [board members] are on the board to care for the well-being and quality of life in the building so they want to make those decisions."

Prepare Yourselves

These preliminary filters set the stage for the committee interview, usually conducted by three board members. The interview itself can be described as a friendly meeting with neither lawyers nor managing agent present. Though otherwise unsupervised, the committee must follow certain guidelines to ensure they don't make themselves vulnerable to any discrimination claims. Both the buyer's and seller's counsel should advise their clients of exactly what they can and cannot ask (or be asked) well before the actual interview.

Bruce Cholst, a partner with the Manhattan law firm of Rosen & Livingston, offers some simple advice: "I very, very, very strongly suggest that boards [review the application] package before the interview." The application committee should go over everything with a fine-tooth comb and craft interview questions before meeting the applicant. Cholst says this puts the board in a position to offer proof of a valid denial if the applicant is turned down and files a lawsuit.

The Interview

After poring over application materials and putting together a list of interview questions, a board is ready to meet the applicant in person. According to Cholst, the interview is the final step taken "to assess through nonverbal communication what the purchaser is like." Cholst advises board members, "Don't forget that when shareholders elect board members, they are trusting board members to protect them against admitting undesirable neighbors. [That can include] the financially unqualified, security threats, and controversial celebrities."

Mayglothling adds, "It's more than financial approval. The interview is to see if the person fits with the character of the building. It's really subjective. You get a vibe on the person ... it could come out that a quiet-seeming person likes to throw 35-person parties every Friday night in a building made up of mostly elderly people."

Most attorneys recommend that interviews be kept friendly but businesslike, and conclude in 20 to 30 minutes. Most also feel that it is in the best interest of the board to keep as little contact as possible with the applicant outside the interview itself.

According to Mayglothling and Cholst, committee members can ask an applicant about who is going to live in the apartment, whether the applicant intends to keep pets, if they intend to physically reside in the apartment or just use it as an investment, and how much traffic from visitors can be expected. Says Mayglothling, "They may not be working from home, but are going to get many FedExes and packages. If there's a family member that stays with them for three months of the year, we may want to know about that. These questions are OK."

Cholst concurs and adds, "The board can be as arbitrary and capricious as they want, as long as they don't discriminate illegally. If you don't like the way the person breathes, the way a person dresses, that's nonverbal communication. The board member can act on intuition. It is a perfectly legitimate basis for rejecting somebody."

If the Answer is No

If, after examining a prospective tenant's application and interacting with them during the interview, the board decides to issue a denial, the committee members speak to their managing agent, who then drafts a letter of rejection. Birbach stresses the importance of letting the managing agent coordinate the approval or rejection process from start to finish. And he adds that the board should not spell out explicit reasons for their denial so as to limit board exposure to future litigation.

According to Chris Hitchcock, a partner at the Manhattan law firm of Ohrenstein & Brown, in order to protect themselves and the co-op in a litigious climate, boards are reversing their approach and involving their attorneys at the outset of rejecting an applicant. "Board members say, 'we think that based on what we see, that this is not a good applicant. Is there sufficient grounds for denial?'"

Both Mayglothling and Cholst note that it is important that neither the board, the attorney, nor the managing agent expresses interest in any characteristic of the buyer that could be construed as discriminatory. For his part, Cholst recommends a simple, one-line refusal. Should the denied applicant ask for a specific explanation, the board's agent should simply say, "we don't provide reasons." Conversely, Rothfeld does say though that

the board should maintain a good paper trail throughout the process. To try and reconstruct a denial, three years or so after the fact, if litigation ensues, can be very difficult.

In response to a board's nondisclosure, Cholst says a deft buyer's attorney will usually submit a letter of arbitration, or speak to the agent to say, in effect, "we really want the apartment. Is there anything we can do?" After that, every effort is made to accomplish a sale. "The object is to get to yes," says Wagner.

Protection From Your Own Decisions

Despite potential legal pitfalls, boards are actually well protected against claims. One of the best ways to ensure protection, said Gonchar, is to have the co-op's governing documents, such as the bylaws and the proprietary lease, fully detail the approval and interview process. According to Cholst, "Whenever board members are confronted with potentially controversial judgment calls with legal implications, they should actively solicit the written opinion of counsel. When they act in accordance with such an opinion, board members will be well-equipped to cite their reliance upon such advice as evidence of their 'reasonable belief' that they are acting in the best interest of the corporation so as to avoid personal liability."

All the same, insurance never hurts. Directors' and Officers' (D&O) insurance can help pay for counsel if a discrimination suit arises, according to Lesnewski. If a board is found guilty, though, D&O insurance is prohibited from paying any court-imposed penalties, she said.

The idea is that paying monetary damages will deter boards from discriminating in the future. David S. Kasdan, an associate with the Manhattan law firm Hoey King Toker & Epstein, says that "The board can fight to the bitter end, but if in the bitter end the board is found guilty, New York State policy prevents indemnification. That was the lesson of Biondi."

Kasdan refers to the case of Biondi vs. Beekman Hill House, a landmark case that threw the issues of discrimination, bad faith, and board liability into sharp relief. In a nutshell, board president Nicholas Biondi was found to have discriminated against Gregory Broome, an African-American man attempting to sublet an apartment in his building, and Shannon Broome, Mr. Broome's Caucasian spouse. Biondi was ordered to pay $124,000 in punitive damages out-of-pocket. Biondi in turn sued the rest of the Beekman Hill board, claiming that they should pay his fine. Though the Biondi case set a precedent, the fact that Biondi was found guilty and ordered to pay punitive damages is unusual; discrimination plaintiffs generally face an uphill battle when suing boards for turning them away.

The Good News

According to Cholst, boards not only have to concern themselves with lawsuits from rejected applicants, but also from shareholders harmed by accepted applicants-gone-bad. Unlike a discrimination situation–in which board members may actually be committing a crime–in the case of a board negligently accepting an unfit applicant, members are making an honest error that Cholst defines as "failing to properly investigate the credentials and backgrounds of prospective purchasers or subtenants, with the lapse resulting in damage to the co-op or to individual shareholders."

Suits of negligence may be dismissed, however, if the co-op's Certificate of Incorporation includes the language of Business Corporation Law Section 402. According to Cholst, the law "permits corporations to include a provision in their Certificate of Incorporation which immunizes board members from personal liability for negligence in the performance of their official duties. To the extent that board members are sued for such conduct and the co-op's Certificate of Incorporation contains the appropriate language, this provision can be cited as the basis for a motion to dismiss the suit." Cholst says that if not currently included, such amendments can be added with a majority vote from the co-op's stockholders should negligence be generally accepted is a matter for stockholders to decide.

Though lengthy lawsuits are expensive, time-consuming public-relations landmines for boards and buildings, any rejected applicant trying to sue for discrimination has their work cut out for them: co-ops have wide approval/denial power, as was shown in the landmark case of Levandusky vs. One Fifth Avenue Apartment Corp. The case set forth precise guidelines for co-ops to follow in order to withstand judicial review in court: "The board's actions must be (i) in furtherance of the purpose of the co-op; (ii) within the scope of its authority; and (iii) in good faith." According to Kasdan, what this boils down to is that the courts of New York State determined that absent illegal discrimination, a co-op board "is under no obligation, and can reject for any reason, or for no reason." Even with this power, however, Kasdan says a wise board will "diffuse potential claims by disclosing their reason [for rejection]. Income is a very strong objective criterion. It's legal to reject if you just don't like [an applicant], but it opens you up to potential claims that you don't like them because of their skin color or sexual orientation."

There's No Such Thing as a Cheap Suit

In the event of an unavoidable lawsuit, Wagner advises his clients to organize an attorney/board meeting immediately to discuss strategy. No minutes should be taken during the session, and no intra-board e-mail discussing the meeting should be sent before or afterwards, as both minutes and e-mail could be summoned in court as proof of discrimination. Strategy meetings of this sort are protected by attorney/client privilege, and are the best means of crafting a board's defense and determining the best course of action.

According to Manhattan attourney Allen Turek of the law office of Allen Turek, the number of discrimination suits filed against co-ops in New York City every year is relatively small, and the number that result in judgments against boards, smaller yet. However, that number is growing and becoming more of a concern, said Gonchar. Statistics are little comfort to boards embroiled in drawn-out, sickeningly-expensive legal battles, though –and never mind boards actually found guilty of discriminating against a prospective buyer. Says Turek, "The atmosphere post-Biondi is more business, less social. The time to be social is not now." Though discrimination suits are difficult to win, they can cost your building tens of thousands of dollars to resolve, regardless of verdict. The moral of the story is: don't discriminate. Protect your building's cachet, your shareholders' investments, and yourself from negligence, but do it for the right reasons–and on the right side of the law.