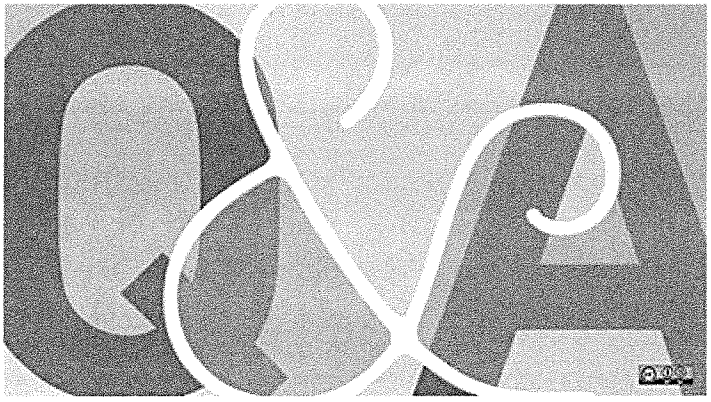
Q&A: Addressing a Possible Conflict of Interest Within a Board

BY MARGERY N. WEINSTEIN 2017 JUNE Q&A



Q. I am a relatively new board member at-large to our HOA board in a small community with 44 homes. I recently learned that our previous treasurer was also receiving a "management" fee of nearly $4,000 a year for several years. I have further been informed that this fee was approved by board vote in which it is believed that the treasurer participated; not by a vote by or disclosure to all homeowners.

My concern is multi-fold: Was this board member receiving compensation in violation of state law? Are we as homeowners entitled to seek reimbursement by this previous board member who also acted as a paid vendor? If so, what steps should be taken to seek recovery as homeowners? Criminal complaints, civil action and/or by way of claim against the association's director and officers (D&O) liability insurance policy which should cover such errors made by the previous board in allowing such payments and financial relationship to take place with the previous treasurer?

As a board member, what actions should our current board (inclusive of some previous board members) be taking, first to record and disclose these recent findings to the entire community and to then ultimately try to take action to correct any inadvertent breaches of fiduciary responsibility by the previous board in allowing those payments to be made to the treasurer?

—How Should We Fix This?

Your E-Mail

SUBSCRIBE TO NEWSLETTER

A. "In New York State, a transaction entered into by an HOA board member is not automatically voided or voidable simply because such board member receives financial gain," says Margery N. Weinstein, Esq., a partner at Ganfer & Shore, LLP in Manhattan. "In order to evaluate the questioner's rights, and the rights and obligations of her HOA board members, the questioner should begin by examining the state's laws that govern the establishment of her HOA. It is also crucial for her to carefully review her HOA's particular governing documents, including its declaration, certificate of incorporation and by-laws, as these are the unique rules that establish the obligations of her particular HOA's board.

"Most HOAs in New York are private corporations established under the state's Not-for-Profit Corporation Law (NPCL). Under the NPCL, as with the New York Business Corporation Law that governs cooperative apartment corporations, members and directors of boards are fiduciaries; accordingly, they must govern with a duty of care for others, rather than to promote their own personal interest or gain. Their fiduciary duties require them to carry out their board responsibilities in good faith and with the best interest of the members of the association's corporate community in mind. This fiduciary obligation of a board member must be evaluated in conjunction with the NPCL provisions governing related party transactions.

"In 2015, the NPCL was amended to clarify the provisions of Section 715, the section which governs related party transactions. While a member or director of a board may be in breach of his fiduciary duties when he acts in his self-interest, both before the 2015 amendments and under the current law, Section 715 does not automatically render as void all transactions entered into by a board and a board member solely because of the financial gain of the director from such transaction. Consequently, the HOA's hiring of the treasurer to manage the HOA may or may not be voidable under New York State law. As we will explore in the following paragraphs of this article, the unique facts of the situation, and the precise wording of the HOA's governance documents, will determine whether a related party transaction, such as the treasurer's receipt of a fee for managing the HOA, constitutes a breach of a board member's fiduciary obligations and a violation of law.

Your E-Mail

SUBSCRIBE TO NEWSLETTER

"Prior to the 2015 amendments, the NPCL did not require board member disclosure of his self-interest, in all instances, in order for a related party transaction to be acceptable. Applying the old law, it is possible that the questioner's board treasurer could have failed to disclose his self-interest and yet the transaction could still be legally allowed so long as such transaction was "fair and reasonable" to the HOA when authorized. The 2015 amendments strengthened the disclosure requirements and eliminated many ambiguities from the former version of the statute. In particular, it clarified that a related party transaction is permissible only when (i) there is proper disclosure to the board "of all material facts" concerning the director's self-interest, so that the board can determine if there is a conflict of interest, and (ii) the transaction was "fair, reasonable and in the corporation's best interest at the time of such determination." Under the current law, both fully disclosing self-interest and passing the "fair and reasonable test" are required to uphold the board's decision to enter into the transaction.

"In determining whether it was fair and proper for the former treasurer (or a company in which he had a financial interest) to receive a management fee, it is important for the questioner to consider the specific factual context in which the board voted to hire the treasurer to act as the HOA's manager. These inquiries should include questions such as whether other companies were also evaluated for the manager position, whether the treasurer's fee was competitive when compared to others in the management industry, and whether he and/or his company were better suited than others to provide the management services for which he was hired. The facts may show that the interested director not only fully disclosed his financial interest, but also, that after sufficient board evaluation, he and and/or his company were seen as best suited for providing particular management services for the HOA. Thus, the transaction with the treasurer would not only be allowable under the NPCL, but also there would be no basis for claiming a breach of the treasurer's fiduciary obligations to the HOA community and no reason to question the board's action to hire him to manage the HOA for a fee.

Your E-Mail
SUBSCRIBE TO NEWSLETTER

"Additionally, under Section 715(d) of the NPCL, unless otherwise provided in the certificate of incorporation or by-laws, an HOA board has the authority "to fix the

compensation of directors for services in any capacity". Under this provision, if the questioner's HOA board properly hired the treasurer to manage the HOA (following disclosure of his self-interest and satisfaction of the "fair and reasonable" test), it would not be a breach of the treasurer's fiduciary obligations to obtain a fee for providing management services unless the HOA's governing documents expressly prohibit board members from being compensated for performing services.

"Notably, commencing with the 2015 amendments, the treasurer's presence at the board vote and/or the treasurer's vote to approve the management company transaction is in contravention of the requirements of NPCL Section 715(g), which states that "no related party may participate in deliberations or voting relating to matters set forth in [Section 715]." In addition, the HOA's certificate of incorporation and by-laws may contain other specific rules relating to situations where there is self-dealing, including rules that further restrict when a board member may, or may not, vote. If such restrictions were in effect but not followed, the treasurer's presence, vote and hiring (and the actions of other members of the board in permitting this to occur) may violate the well-established fiduciary duty standards required of board members.

"In determining whether either the HOA's newly elected board or its residents should take action against the former treasurer and/or other former board members, the questioner would be wise to carefully review her HOA's governing documents. As an initial matter, the questioner should determine whether her HOA has a conflict of interest policy in place which adheres to Section 715-a of the NPCL and which defines the specific circumstances that constitute a conflict of interest. If the HOA's governing documents do not contain the required conflict of interest policy, the new board should institute one immediately. A clear conflict of interest policy should create a structural framework against which board members and HOA residents can evaluate potential conflicts of interest (such as related party transactions) as they occur, so that such transactions are not questioned at a later date.

Your E-Mail

SUBSCRIBE TO NEWSLETTER

"The questioner's allegations against the former treasurer - that he may have acted for his personal gain in violation of his fiduciary obligations and in violation of law - are quite serious. There can be severe repercussions to a board member's abuse of power and breach of his fiduciary duties; if misconduct is proven, the treasurer may be held personally liable and suffer monetary damages, including legal fees, and he will not be shielded by any director's and officer's liability insurance. Therefore, if after extensive analysis the questioner still believes there is validity to her allegations, the best approach would be for her to advise her current board to consult with an attorney.

"The attorney should conduct an independent internal investigation. Depending upon his findings and the severity of the wrongdoing, he may counsel the current board to contact the state's attorney general's office if the facts reveal that the transaction with the Treasurer violated NPCL Section 715. Until the 2015 NPCL amendments, the Attorney General's office only regulated the initial offer and sale of HOA interests and there was no state agency empowered to become involved in HOA board member issues once the initial sponsor ceded control to residents. Section 715(f) of the law now gives the attorney general's office various powers over related party transactions, including the power to bring an action to enjoin, void, or rescind the transaction or to seek an accounting of profits made from such transaction and pay them to the HOA.

"Additionally, regardless of whether the attorney general's office decides to pursue an action, the attorney should assist the questioner's HOA board in evaluating whether commencing its own legal action would be appropriate. If there is sufficient merit to the claim against the former treasurer, the board may have the fiduciary obligation to its residents to seek damages by filing a legal claim. At the same time, the board would want to notify its director's and officer's liability insurance carrier that it is claiming director's malfeasance. However, if the facts are ambiguous and/or the amount of damages insignificant, the board may decide that taking legal action against the treasurer would be inappropriate for a variety of reasons, including the cost of legal proceedings and the time, effort and toll it make take to collect. Most importantly, the board may determine not to pursue legal remedies because a law suit against a former board member may not

Your E-Mail
SUBSCRIBE TO NEWSLETTER

be in the best interests of the HOA community; the existence of such a suit may have a detrimental effect on property values, may curb its members from volunteering to serve on the HOA's board, and is likely to destroy the cohesive fabric of the HOA community, pitting neighbor against neighbor.

"There are possible remedies available to individual members of the HOA as well. The most immediate action that residents may take would be to call for a vote to remove from the current board any former board members who condoned, either by action or inaction, the treasurer's self-dealing. In addition, if individual residents of the HOA disagree with a board decision not to pursue legal remedies, they may be able to bring a derivative claim on behalf of the HOA's board seeking to recover damages for the treasurer's improper actions. Of course, this option should be weighed carefully against the many pitfalls of litigating, as enumerated in the prior paragraph.

"It is outside of the scope of this response to discuss possible criminal sanctions against the treasurer. Based on the facts provided, no element of theft or willful misconduct appears to have been involved, either in the treasurer's actions or in the board's approval of the related party transaction."

Your E-Mail

SUBSCRIBE TO NEWSLETTER