Originally published in

New York Law Journal

Cooperatives and Condominiums

July 5, 2017

Conflicts of Interest: A Broker on the Board


By Eva Talel and Richard Siegler

Cooperative and condominium boards are entrusted by apartment owners with responsibility for managing the affairs of their building. Boards make many types of decisions, from deciding (in the case of co-op boards) who gets to purchase an apartment to choosing the color of the carpet in the building's hallways. Apartment owners generally understand that board members are fiduciaries and therefore expect that boards must make such decisions and take actions which are in good faith and in the best interest of the cooperative or condominium community as a whole, and not for a board member's personal interest or gain.

But what happens when a director has a personal interest that is separate and apart from the interest of the cooperative or condominium, collectively, on whose board they serve? A director in this position may have a conflict of interest.

A frequently encountered example of such a facial conflict is when a director has also brokered a transaction for the sale of an apartment in the building, which transaction the board is evaluating. On the one hand, such a broker/director wants the transaction to proceed to closing

and collect a brokerage commission; on the other hand, the director also has the responsibility of fully vetting the potential purchaser and, if appropriate, rejecting the purchase application. What course of action should the broker/director and, more importantly, the board take in order to comply with the law and avoid potential litigation?

This column first summarizes the law addressing such potential board member conflicts of interest, focusing in particular on the broker-as-board-member scenario.[1] We examine the duty of care, the business judgment rule, the definition of an interested director and safe harbor provisions that can save a transaction from being successfully challenged. We also provide recommendations on how a board can navigate conflicts of interest and minimize the risk of litigation.

Indeed, the importance of insuring that conflicts of interest do not arise has gained the attention of the New York state legislature. Some two weeks ago, a bill was passed by the New York State Senate and returned to the Assembly for a vote, which bill would add a new section to New York's Business Corporation Law requiring all co-ops and condominiums to provide annual reports to their shareholders/apartment owners detailing any contracts made by the board where one or more of the board members was "interested."[2]

Director's Duty of Care

A co-op director is a fiduciary who owes a statutory duty of care to shareholders, which means that the director must serve "in good faith and with that degree of care which an ordinarily prudent person in a like position would use under similar circumstances."[3] A co-op, like other corporations, can indemnify directors against alleged violations of the duty of care. Such indemnification can be directly authorized by the certificate of incorporation or the by-laws, or if permitted by such certificate or by-laws, authorized by a resolution of the shareholders or directors.[4] Similarly, condominium directors owe a fiduciary duty to their unit owners and can be indemnified pursuant to the condominium's by-laws.[5]

However, directors cannot be indemnified if they acted in bad faith, were deliberately dishonest or personally gained a financial profit or other advantage.[6] For example, a director

---

1 This column updates and expands on an earlier one. See Siegler and Talel, "Interested Directors: Applicable Statutes, Cases, Guidance," NYLJ, July 5, 2007, pg. 3, col. 1 ("Interested Directors").

2 NY Assembly Bill A.8261, NY Senate Bill S.6652A 2017-2018 Session.

3 N.Y. Bus. Corp. Law §717(a) (McKinney 2017).

4 N.Y. Bus. Corp. Law §721 (McKinney 2017).

5 *Board of Managers of Fairways at North Hills Condominium v. Fairway at North Hills*, 193 A.D.2d 322 (2d Dept. 1993); "Interested Directors," supra note 1.

6 Id. "… no indemnification may be made to or on behalf of any director or officer if a judgment or other final adjudication adverse to the director or officer establishes that his acts were committed in bad faith or were the

who violates federal campaign finance laws or commits grand larceny cannot be indemnified for such actions. Interested directors who personally gain from a transaction must pay their own legal expenses and damages awarded against them, regardless of any indemnification agreement.[7]

Business Judgment Rule

If a co-op or condominium board fulfills its fiduciary obligations, its actions are given great deference by the courts under the business judgment rule. In the landmark case of *Levandusky v. One Fifth Ave. Apartment*,[8] the New York Court of Appeals held: "So long as the board acts for the purposes of the cooperative [or condominium], within the scope of its authority and in good faith, courts will not substitute their judgment for the board's."

Although the business judgment rule provides board actions with substantial protection, this protection can be vitiated if a director is in breach of his or her fiduciary duty. A plaintiff/apartment owner would have to allege a factual/evidentiary basis for the alleged breach, such as testimony or documents showing a director's conflict of interest or misconduct. If the court finds such factual allegations credible, it may then delve into the substance of the challenged board action and possibly overturn it.[9]

A director who brokers an apartment purchase and later demonstrably participates in board review of the purchase application package could present a factual basis for a court to set aside the business judgment rule and evaluate the board's action in substance.[10] To avoid this outcome and the possibility of a transaction being challenged and voided, we now turn to the definition of an interested director and the measures a board can adopt to avoid such potential conflicts of interest.

Who Is an Interested Director?

Directors are interested if they receive a direct financial benefit which is different from the benefit generally received by other apartment owners.[11] With regard to broker-directors, they are "interested" because the brokerage commission they would receive from a board-approved

---

result of active and deliberate dishonesty and were material to the cause of action so adjudicated, or that he personally gained in fact a financial profit or other advantage to which he was not legally entitled."

7 *Bansbach v. Zinn*, 1 N.Y.3d 1 (2003); *Pilipiak v. Keyes*, 286 A.D.2d 231 (1st Dept. 2001).

8 75 N.Y.2d 530, (1990). The court expressly held that its decision also applies to condominium board actions. 75 N.Y.2d 530, 536.

9 *Jones v. Surrey Co-op. Apartments*, 263 A.D.2d 33 (1st Dept. 1999).

10 Id.

11 *Shapiro v. Rockville Country Club*, 22 A.D.3d 657 (2d Dept. 2005).

apartment sale is a direct financial benefit to them that is not shared by other apartment owners.

Beyond such direct financial benefits, a conflict of interest can also exist if a director is reviewing and acting upon a transaction between the co-op/condominium and another corporation, and the director sits on the board of both entities.[12] A director is similarly conflicted (despite receiving no direct benefit from the transaction) if he or she is controlled by another interested director.[13]

Broker-directors would thus be "interested" if they participate in a board review and determination as to a transaction which they brokered. In such situations, broker-directors would be well-advised to recuse themselves from the decision-making process in order to avoid allegations of a conflict of interest. However, occasions nonetheless may arise in which the broker-director is present for or participates in the board review. For example, a director in a senior position at a large brokerage firm may not be aware of the fact that one of the firm's employees brokered a transaction which the co-op/condominium director is now reviewing. Is the transaction now void or voidable? We therefore next discuss three safe harbor provisions that can save a transaction from being voided and directors from liability.

Safe Harbor Provisions

First, interested directors can disclose the material facts of their interest in the transaction to the board. If the board (without counting the vote of the interested director) approves the transaction, then the transaction is legally valid. If the number of disinterested directors fails to constitute a quorum, then a unanimous vote of the disinterested directors would be required to preserve the transaction from a successful challenge.[14]

Second, interested directors can disclose the material facts of their interest in the transaction to the apartment owners. If, in a co-op, the shareholders approve the transaction, then the

---

[12] N.Y. Bus. Corp. Law §713(a) (McKinney 2017). "… contract or other transaction between a corporation and one or more of its directors, or between a corporation and any other corporation, firm, association or other entity in which one or more of its directors are directors or officers, or have a substantial financial interest … ."

[13] *Barbour v. Knecht*, 296 A.D.2d 218 (1st Dept. 2002); *Park River Owners v. Bangser Klein Rocca & Blum*, 269 A.D.2d 313 (1st Dept. 2000).

[14] N.Y. Bus. Corp. Law §713(a)(1) (McKinney 2017). "If the material facts as to such director's interest in such contract or transaction and as to any such common directorship, officership or financial interest are disclosed in good faith or known to the board or committee, and the board or committee approves such contract or transaction by a vote sufficient for such purpose without counting the vote of such interested director or, if the votes of the disinterested directors are insufficient to constitute an act of the board as defined in section 708 (Action by the board), by unanimous vote of the disinterested directors[.]"

transaction is also valid. Although this method would be more cumbersome than a board vote, it can be used if a unanimous vote of disinterested board members cannot be secured.[15]

Third, if neither approval from the board or the shareholders is secured, the transaction is still legally valid if the board can demonstrate to a court that the transaction is fair and reasonable.[16] This can be difficult to do, and courts are loath to delve into the substance of such board decisions.[17] In dealing with an apartment sale transaction, a court may then need to inquire into the market value of the apartment in question as well as the qualifications of the applicant.[18]

Recommendations

A director who participates in board action with regard to a transaction that he or she brokered has a conflict of interest. The best course of action would be for such a director to recuse himself or herself. If he or she does not do so, a transaction can still be legally valid if the requisite board or apartment owner approval is obtained, or if the board can demonstrate the fairness and reasonableness of the transaction. A board has two preemptive tools for dealing with interested director transactions, short of relying on safe harbor provisions, to protect a transaction from challenge. It can appoint an independent committee of the board to review the transaction and establish a conflict of interest policy to guide board members to avoid conflicts in the first instance.[19]

If a board creates an independent committee consisting of disinterested directors to evaluate a transaction, the committee's decisions are protected under the business judgment rule.[20] Further, the entire board can rely on such committee's findings in its decision-making, so long as its reliance is in good faith.[21]

---

[15] N.Y. Bus. Corp. Law §713(a)(2) (McKinney 2017). "If the material facts as to such director's interest in such contract or transaction and as to any such common directorship, officership or financial interest are disclosed in good faith or known to the shareholders entitled to vote thereon, and such contract or transaction is approved by vote of such shareholders."

[16] N.Y. Bus. Corp. Law §713(b) (McKinney 2017). "If a contract or other transaction between a corporation and one or more of its directors, or between a corporation and any other corporation, firm, association or other entity in which one or more of its directors are directors or officers, or have a substantial financial interest, is not approved in accordance with paragraph (a), the corporation may avoid the contract or transaction unless the party or parties thereto shall establish affirmatively that the contract or transaction was fair and reasonable as to the corporation at the time it was approved by the board, a committee or the shareholders."

[17] See *Levandusky v. One Fifth Ave. Apartment*, 75 N.Y.2d 530, 539 (1990).

[18] *Alpert v. 28 Williams Street*, 63 N.Y.2d 557, 571 (1984).

[19] See Siegler and Talel, "Interested Directors: Applicable Statutes, Cases, Guidance," NYLJ, July 5, 2007, Vol. 238, No.3.

[20] *Auerbach v. Bennett*, 47 N.Y.2d 619 (1979).

[21] N.Y. Bus. Corp. Law §717(a)(3) (McKinney 2017).

A board would also be prudent to consider establishing a conflict of interest policy, which both educates directors regarding conflict issues and establishes policies for addressing the same. Such a policy could be adapted periodically to accommodate evolving challenges. Adopting such a policy would help alert directors and boards to potential conflict issues, triggering timely recusals, creation of an independent committee and/or the use of a safe harbor provision.[22]

Eva Talel is a partner at Stroock & Stroock & Lavan and an adjunct professor at New York Law School. Richard Siegler is of counsel to the firm. Stroock's Yee Hong, an associate, and Margaret Jones, a research librarian, assisted in the preparation of this column. The firm is counsel to the Real Estate Board of New York.

[22] See "Interested Directors," supra note 1.