

## **Fiduciary Duties of Boards of Directors in the Real Estate Industry**

By John Dolgetta, Esq.

“Fiduciary duty” is a critical element of successful day-to-day business operations and interactions in the real estate industry. Such duties apply to any industry for that matter. While many real estate agents, members of boards of directors and officers of organizations and corporations are familiar with the term “fiduciary duty”, very few understand its full import. Such duties apply to anyone acting as an agent. It imposes obligations upon organizations, professions, corporations and their executives, shareholders, members, clients, customers and the public in general. This article will outline the key elements of “fiduciary duties” and highlight their importance to the real estate industry.

### What Is Fiduciary Duty?

A “fiduciary duty” is a standard of care similar to the standard defined in Business Corporation Law Section 717 which states that “[d]irectors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions.” This standard of “diligence, care and skill” is also referred to as the “Prudent Person Rule.” The first question any director or officer should ask before he or she acts in his or her officer or director capacity is: “What would a prudent person in the same or similar position do?” While the question posed seems easy enough to answer, many who undertake this responsibility are unable to answer it adequately and ultimately fail to act in the manner required by law. The fiduciary duties of officers and directors are amongst the most critical elements of effective and successful functioning of any organization.

### What is a Fiduciary?

A fiduciary is a person or entity who or which acts on behalf of another in a position of trust and confidence. It is the role having the highest standards known in law. It includes guardians, trustees, executors, officers, directors and persons acting in an agency capacity. Just as in real estate transactions, fiduciaries have the duties of undivided loyalty, confidentiality, full disclosure, obedience and the duty to account.

### The Duty of Care

Any officer or director acting in a fiduciary capacity must act in good faith and exercise a prudent “duty of care, skill and diligence” when acting on behalf of the entity served. In a pamphlet entitled “*Right From the Start: Responsibilities of Directors and Officers*”, prepared and offered by the New York State Office of the Attorney General, it is explained that the “duty of care requires a director to be familiar with the organization’s finances and activities and to participate regularly in its governance.” (A copy of the publication can be found at <http://www.charitiesnys.com/pdfs/Right%20From%20the%20Start%20Final.pdf>).

These duties require that all directors and officers be actively involved in board meetings and know about and understand what the organization is doing or planning to do. They must

attend meetings regularly and actively participate. The Attorney General's office points out areas of concern (relevant portions of the text are restated below) that directors and officers should be aware of and should do when exercising the duty of care:

- They should carefully read the material prepared for board and committee meetings prior to the meetings and note any questions they raise.
- Read the minutes of prior meetings and all reports provided, including financial statements and reports by employees.
- Make sure her or his votes against a particular proposal are completely and accurately recorded.
- Make sure to get copies of the minutes of any missed committee or board meeting and read them timely, suggesting any changes that may be appropriate.
- Make sure there is a clear process for approval of major obligations such as [annual budgets,] fundraising, professional fees (including auditors), compensation arrangements and construction contracts.
- Make sure that board minutes reflect any dissenting votes...[and if appropriate, request that a]...dissenting vote [be] expressed in writing by letter to the board. Such records are necessary in order for a board member to disclaim responsibility for any particular decision. Absent board members must do this promptly in writing.
- Participate in risk assessment and strategic planning discussions for the future of the organization.
- Insure that the organization has addressed the sufficiency of its written internal financial controls and written policies that safeguard, promote and protect the organization's assets.... [These controls and policies must be] updated regularly. Obtain an employees, officers and directors fidelity bond to protect the organization from embezzlement. Have a policy regarding disclosure and identification of fraud (whether or not material). Make sure a policy for records retention and whistleblower protection is in place.
- Create a background check policy for prospective employees.
- Encourage diversity among board members. Diversity will help insure a board committed to serve the organization's mission with a range of appropriate skills and interests.
- Be involved in the selection and periodic review of the performance of the organization's Chief Executive Officer, Chief Financial Officer and other key employees responsible for the day-to-day activities of the organization. The board [of directors] is responsible for ascertaining whether these individuals have the appropriate education, skills and experience to assume a key position....

The list of items above offered by the Attorney General's office is only small sampling of what directors and officers should be aware of when exercising the duty of care. It is strongly recommended that one review in depth this publication offered by the New York Attorney General's office.

## The Duty of Undivided Loyalty and Issues Regarding Conflicts of Interest

When acting in the role of director or officer, the individual serves only the interests of the entity. This is known as the duty of undivided loyalty or the duty of loyalty. He or she does not stand as an advocate for their firm or for any political or other point of view, but rather functions as a fiduciary on behalf of the organization or entity. The Attorney General's office explains in its pamphlet that "[d]irectors are charged with the duty to act in the interest of the corporation. This duty of loyalty requires that any conflict of interest, real or possible, always be disclosed in advance of joining a board"...as well as when such conflicts arise. Board members must avoid transactions in which they or their family members benefit personally. If such transactions are unavoidable then such conflicts must be disclosed fully and completely to the board. The duty of loyalty mandates disclosure of any conflicts of interest.

In the event that any conflict of interest exists between any individual director or officer and the organization he or she serves, the conflict of interest must be revealed to the Board of Directors. Section 715 of the Not-For-Profit Corporation Law ("NFPCCL") states in pertinent part the following:

**“(a) No contract or other transaction between a corporation and one or more of its directors or officers, or between a corporation and any other corporation, firm, association or other entity in which one or more of its directors or officers are directors or officers, or have a substantial financial interest, shall be either void or voidable for this reason alone or by reason alone that such director or directors or officer or officers are present at the meeting of the board, or of a committee thereof, which authorizes such contract or transaction, or that his or their votes are counted for such purpose:**

- (1) If the material facts as to such director's or officer'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 authorizes such contract or transaction by a vote sufficient for such purpose without counting the vote or votes of such interested director or officer; or**
- (2) If the material facts as to such director's or officer'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 members entitled to vote thereon, if any, and such contract or transaction is authorized by vote of such members.”**

In essence, the law and prudent thinking require that conflicts of interest be fully and completely disclosed and that any interested director or officer abstain from any discussion or vote on the matter.

Section 715(b) therefore, provides that “[i]f such good faith disclosure of the material facts...” is made, the corporation may not avoid the contract or transaction. Section 715(b), however, further provides that “[i]f there was no such disclosure or knowledge or the vote of such interested director or officer was necessary for the authorization of such contract or transaction...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....” So, while the law allows for transactions and contracts to be still held valid in certain instances, the organization’s certificate of incorporation, bylaws or other organizations documents or corporate policies may prohibit such transactions and should be reviewed carefully.

In a publication entitled “*Board Development and Accountability*” prepared by Linda Manley, Legal Director of the Lawyers Alliance for New York, Ms. Manley states that the duty of loyalty “[r]equires that board members pursue the interests and mission of the organization with undivided allegiance.” This “undivided allegiance” requires that a director or officer place the interests of the organization above his or her own. The publication points out that there should be a clear conflict of interest policy in place. In addition, board members and officers should be aware that the doctrine of diversion of corporate opportunity applies to them. Board members or officers are not permitted to take advantage of a corporate or business opportunity first offered to the entity which he or she serves. If corporate opportunities, information or assets are used for their own pecuniary gain they are in breach of the fiduciary duty of loyalty. (For a copy of the above publication please visit <http://www.nyc.gov/html/nonprofit/downloads/pdf/Board%20Development%20and%20Accountability.pdf>).

### Duty of Confidentiality

Unless otherwise communicated to the membership or the public, any actions taken by directors and officers or any information made available to the officers or directors must be maintained on a strictly confidential basis by each director and officer. As fiduciaries, directors and officers of corporations have classic fiduciary responsibilities, one of which includes the duty of confidentiality. As any agent or fiduciary is required to do, directors and officers must maintain confidentiality regarding any and all matters that could affect the organization’s competitive position (e.g., merger plans, business plans, strategic business alliances, etc.) and its successful operation.

### Are Officers and Directors Personally Liable For Their Actions?

Board members and officers are in most instances not personally liable for the liabilities of the corporation. Under corporate law these individuals are protected under certain theories known as the “corporate veil” and the “business judgment rule.” The law affords these individuals special protections so that they may act in their fiduciary capacities and discharge their fiduciary duties without the fear of being sued or being held personally liable, in most instances. If a director or officer of a corporation performs his or her duties in compliance with corporate law, he or she will be protected by the “business judgment rule” and in turn, no liability by reason of being or having been a director of the corporation will attach to the individual. However, if an officer or director has breached his or her fiduciary duty, then civil liability, as well as criminal liability, could be imposed. All directors and officers must make informed decisions based on information which is deemed to be reliable and competent.

NFPCL Section 720-a provides that an officer or director may be held personally liable for certain actions if “... (i) the director or officer acted with gross negligence or (ii) intended to cause the harm that resulted to the person asserting liability.” Officers and directors are never protected from liability in the event they act without authority and cause harm to others. Moreover, any act which constitutes a criminal act (i.e., antitrust violations, fair housing violations, etc.) are not protected under the various theories such as the “business judgment rule”, the “Prudent Person Rule” or the “corporate veil.”

### Errors and Omissions Coverage for Officers and Directors

By including indemnification provisions in its Certificate of Incorporation or its Bylaws, an entity can indemnify officers and directors provided they acted in accordance with their fiduciary duties. All of the resources of the organization can be made available to the director or officer to defend against the charges filed. In addition, most corporate entities insure their directors and officers by maintaining errors and omissions insurance coverage. In the case of the Boards of Realtors®, errors and omissions coverage is provided without cost through the National Association of Realtors® to all of its member associations and their subsidiaries. It is always recommended that, even where such coverage is provided, higher levels of coverage be obtained and additional premiums paid in order to increase the levels of coverage which relate to the activities of Realtor® associations, their subsidiaries (i.e., multiple listing services) and especially their directors and officers.

### Fiduciary Duties and Their Importance!

While it is very difficult to adhere to the standards outlined above, successful organizations need individuals who place the interests of the organizations they serve above their own. The individuals who choose to serve Realtor® Boards and similar not-for-profit organizations are often willing to give up significant portions of both their personal and professional lives. Without them these organizations would cease to exist or, at the very least, cease to function effectively. While it is always easier for many to choose not to become a director or officer and not to take on the responsibility required under the law, becoming a fiduciary and discharging one’s fiduciary duties in a professional manner should be viewed as an honor and privilege.

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