

Risks & Liabilities Facing Cooperative Managers

a presentation made by Randall A. Pentiuk

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Introduction

In keeping with the pre-Halloween season, I want to subtitle our class as “The House of Horrors.” This is a reality class based on real life experiences where Cooperatives and their Managers are placed in difficult and sometimes untenable situations. Here are the stories. They are based on fact. Yes, the names have been changed to protect the innocent. And here are the lessons learned - which is the real point of the class.

Points to Ponder: As we walk the hallways of our House of Horrors, it may be beneficial to consider the following:

1. These are real situations. I have been practicing Coop Law in the Midwest - Michigan to be exact - for over two decades. I did not have to make these stories up; they came to me through real cases. It can happen to you.

2. Each of these situations were avoidable. Someone dropped the ball in each case. We hope that by revealing these horrors, you will be able to avoid them.

3. This may be the tip of the iceberg: This class is interactive, and we hope to hear of other horror stories from those attending today. Please feel comfortable to share in an effort to help educate one another.

4. More important than anything else that can be learned in this class is the “golden rules” that we will discuss when we conclude the class. Horrors of yesterday will give way to new horrors tomorrow - the lasting value of a class like this is to find resources to help you deal with the future’s problems.

5. Our goal is not to make legal experts - your job is hard enough. Rather, we seek to introduce you to some practical knowledge and advice that you can take back home. This is not a substitution to getting good legal advice tailored to your particular circumstances and under your laws, governing documents and facts.

6. While the topic is “risks and liabilities” we are not just discussing legal issues - although the context may arise in the legal arena. Rather, what is covered today is a smorgasbord of legal advice, mixed in with practical suggestions to help you avoid the risk of shortening your career, as well as helping the Cooperative avoid pitfalls of all kinds including HUD problems, internal membership upheaval, as well as legal liabilities.

Horror Story #1: The Construction Lien Problem

Scenario: A Board hires a contractor to give the Cooperative a long overdue face lift. The Manager takes care of paying the contractor draws as they are submitted. The Manager makes sure the work is, in fact, completed and is satisfactory. The contractor gets paid. Unfortunately, the companies that did the actual work and supplied the materials did not get paid. They slap a lien on the Cooperative property and begin to foreclose on it. The Cooperative is forced to pay the bills for these subcontractors and suppliers.

The Board fired the Manager and sued him. The Cooperative also sued the contractor but he filed bankruptcy and went out of business, of course.

Lessons Learned:

1. Know your State's Construction Lien Act. It is designed to protect subcontractors and suppliers, to make sure they get paid. It requires strict compliance. There is no room for error.

2. Do not assume professionals understand this law. In our case, the Management Agent admitted his ignorance and is defending on the basis that he never claimed he did, nor did HUD require him to!

3. There are additional protections, such as payment bonds. Governments typically require such measures, but realize that it adds to the contract price.

Horror Story #2: Failing to Turn Over Lawsuits to Insurance Carriers

Scenario: A Cooperative gets hit with a civil rights complaint from a governmental agency, based on allegations by a member that it failed to provide a reasonable accommodation. The matter goes to an administrative hearing where the administrative law judge finds against the Cooperative. A federal court lawsuit is filed, and the complaint is then turned over to the insurance carrier. But the insurance carrier denies coverage, stating that it was prejudiced by not being able to defend the case at the administrative hearing stage.

To add insult to injury, a second member at the same Cooperative files suit in state court. This lawsuit was not turned over to the insurance carrier until late in the game. Again, coverage is denied. Think of the embarrassment of paying premiums and not getting the benefit of the insurance policy!

Lessons Learned:

1. It is never too early to involve the insurance carrier. If there is going to be testimony taken at an early stage, make sure you do not fall into the trap of “prejudicing” the carrier.

2. Have a written procedure to ensure proper handling of lawsuits, administrative investigations and complaints from HUD, Department of Justice, the IRS, EEOC, or your State’s Department of Civil Rights, etc., and include notification of the insurance carrier in the process.

Horror Story #3: The Bum Insurance Carrier

Scenario: A lawsuit is filed against the Cooperative. You turn it over for coverage and then hear nothing. You contact the insurance carrier, and still no response. You look at the policy and see that it is based off shore in some island. Your attorney contacts the principals in some island and is told that he can come down and try to sue there. You now have a sinking feeling that you have been scammed. You are right!

This has also happened to some municipalities with both off shore insurance companies as well as some in under-regulated states; and with surety bonds as well as liability policies.

Lessons Learned:

1. Do business with insurers that are registered and licensed in your State. This assures some degree of regulatory oversight and protection.

2. Make sure to check the financial rating of the insurance company. Use a service like AM Best.

3. Check the State records to see how the insurance company has performed by asking for history of complaints made with the State agency responsible for overseeing such matters.

4. Have a back up plan. Have the Cooperative Attorney takes steps to defend you while you are waiting for the insurance carrier to respond. Usually, plaintiff attorneys will respond favorably to a request for an extension to file an answer to the complaint since they prefer to deal with insurance carriers. In any event, do not leave the plaintiff’s attorney uninformed - you may find yourself with a default judgment problem.

Horror Story #4: Reasonable Accommodations

Scenario: The duty to provide reasonable accommodation to those claiming to have disabilities has become a landslide, with all kinds of issues. Horror Story #2 above dealt with dogs for depressed members - who had doctors give them supporting medical opinion that having these pets - contrary to the Coop's rules - would help them deal with depression. Other examples include having a wheelchair ramp that violates local code despite management's efforts to install an electric-powered lift.

With the Americans with Disabilities Act coming into its own, coupled with the Fair Housing Act Amendments and other federal and state laws, this is one of the hottest, riskiest areas of the law today.

We are seeing routine eviction actions met with counter-complaints that these are in retaliation to the member's request for reasonable accommodation. It is in vogue.

Lessons Learned:

1. This area of the law requires not just expertise, but a crystal ball. The law is developing daily, throughout courts and agencies across America. Beware of anyone who says they can give you a definitive answer. The best lawyers are going to research the most recent rulings since it truly is evolving as we speak, and the stakes are too high to make a mistake.

2. Be sensitive when members talk with you. Record exactly what was said and put into a file; it is likely that their version of the conversation will be sharply more in their favor than what you actually heard. So, if anyone starts talking about their handicap, their disability, their problem, pick up on that and take notes as soon as practicable; then consult with your expert to see if a claim is in the making.

Horror Story #5: Ambiguities in Contracts

Scenario: A contractor is hired to replace gutters at the Cooperative. Upon removal, it is noted that the underlying wood is rotten and needs to be replaced. He is told to stop and submit a bid. He files suit on the theory that part of his bid and the contract allowed him to charge for wood he replaced. The Cooperative never anticipated that all the wood needed replacement. His claim amounted to millions, using the unit price in the bid and since he was not allowed to complete the job, he felt he was entitled to all of it.

Lessons Learned:

1. Define the scope of work in a contract carefully. Play a game of "what if's" to help you identify worst case scenarios and make sure you spell them out in the agreement.

2. Deal with unexpected results with a "force majeure" clause and include these unexpected outcomes in it.

3. Beware of unit pricing. It is a useful tool but consider putting ceilings on it. You may also want to break a big job into smaller segments. Bid the phases and award them separately - even if to the same contractor.

4. Document contacts with the contractor. Always make a record of discussions, and if possible, get him to sign the papertrail.

Horror Story #6: The Slow Contractor

Scenario: The Cooperative hires a contractor to perform a job. You wait patiently for work to begin. It does not start. You contact him again. No action. You start sending him demand letters. His response is that he will do it when he gets around to it.

A related situation is the contractor who never finishes. This was the basis for the old “Murphy Brown” television program - remember the painter who never finished her apartment?

Lessons Learned:

1. All contracts should spell out a date for commencement and a date for completion.
2. Consider “liquidated damages” and perhaps “early completion incentives” to punish and reward contractors accordingly.

Horror Story #7: The Fly-By-Night Contractor

Scenario: The Cooperative, driven by the desire to lower its costs, hires a small contractor - perhaps out of a sense of benevolence - to help a new business out. The owner brings along a friend to help him out, and a saw cuts his arm off. It turns out that the new businessman does not have workers compensation so the injured party sues the Cooperative. If there had been workers compensation, that would have been his only recourse. Instead, the Cooperative ends up paying medical bills and personal injury damages.

Lessons Learned:

1. Always insist on proof of workers compensation coverage before letting work begin.
2. Realize that it is a cost of doing business and that the reason a bidder may be able to undercut others is that he is cutting corners on essential legal requirements. Trying to be thrifty may cost you in the end.

Horror Story # 8: The Factoring Game

Scenario: The Cooperative received a notice that said that it should pay all monies due a contractor to some “factoring company” down in Texas. Thinking that the agreement says that the contractor is forbidden from assigning the contract to a third party unless the Cooperative consents in advance, the Manager disregards the notice. Later, the factoring company sues and the Cooperative is required to pay the factor the same amount it previously paid the contractor.

Lessons Learned:

1. Factors are a special arrangement recognized under the Uniform Commercial Code and falls outside the nonassignability clause.
2. Ignoring a factoring notice costs you double - you will end up paying the factor and good luck collecting from the contractor. If he had any money in the first place, he would not be dealing with a factor.

Horror Story #9: The Grudge Match

Scenario: What seems like a routine member problem turns into a bitter court battle between two members of the Cooperative, one of whom happens to be on the Board. It turns out that the Board member who led the charge to seek the eviction of another member harbors a grudge and is using her position on the Board to bring to bear the resources of the Cooperative to the fight. As the court case progresses - and legal fees mount - it becomes apparent for what it is. And there may be a counter-complaint against the Cooperative. Both sides become entrenched and the war rages on.

Lessons Learned:

1. While it may be a thorny situation, as soon as the Manager gets a hint that this is a grudge match, that information needs to be shared with the Cooperative Attorney, who has the duty of being frank with the Board about the merits of the case.
2. To the extent possible, the Manager and Cooperative Attorney should meet and confer on any non-routine case before it gets filed. Witnesses and records need to be gathered by the Manager to assist the Cooperative Attorney in evaluation the case in its earliest stages.

Horror Story #10: Loose Lips of Board Members Sink Ships

Scenario: During closed sessions, sensitive information of a personal nature is discussed about a member, or the Board has strategy discussions with the Cooperative

Attorney. Later, it is discovered that one of the Board members disclosed the confidential information.

Lessons Learned:

1. Require each Board member to sign a statement that reminds them of their fiduciary duties, including to handle such information in the strictest of confidence.
2. If the violator can be pinpointed, the Board should adopt a resolution of censure and publicize it to the membership. While the Board cannot remove one of its members, it has the duty to inform the membership of the indiscretion, which is a breach of fiduciary duty. This should be only done after a “due process hearing” is held which confronts the accused with the evidence known and affords her the opportunity to rebut it.
3. If the violator is an officer of the Board - such as the Secretary - giving that individual special access not otherwise available to the rest of the Board, [sometimes Secretaries will say they tape closed sessions to help them prepare minutes], the Board may reorganize itself and strip that person of the office that enabled her to breach her duty.

Horror Story #11: The Dangerous Member

Scenarios: Cooperative members have exhibited odd behavior, ranging from peeking into units [or in one case, drilling a hole in the ceiling of another unit from the attic], to storing gasoline in the basement, to grabbing a little child by the throat at the annual picnic because a frisbee hit him in the head, to stabbing his girlfriend and leaving her dead in the unit with an infant in the next room. Other cases have included members who committed crimes off-site, or had criminal sexual conduct convictions discovered after moving in. We have seen cases where a member randomly shot off rounds in a Detroit high rise and staged a standoff with the police, culminating in a shoot-out that left her dead.

Lessons Learned:

1. Trouble can strike at any hour, and at any Cooperative. You must have 24/7 access to the members of the Cooperative team: the Board members, your maintenance staff, the Cooperative Attorney. Damage control does not always wait. The reporters, membership, and law enforcement authorities will not wait. Be prepared for a crisis by at least being able to reach the key players.
2. Act swiftly to protect other members and Cooperative property. Be sure to consult a knowledgeable Cooperative Attorney that knows the most expeditious ways of getting cases into court. In some states, drugs or criminal activity are given fast track

through the court system, as if cases where the allegations deal with health hazards - like roaches, explosives, fire-prone members.

3. Remember HUD has a zero tolerance rule for drug activity.

Horror Story # 12: Missing Records

Scenario: The Board has five directors but the bylaws say that there should be seven. Some folks recall that there was a proposed amendment to the bylaws “back a few years ago” but no one can find the paper trail to indicate that the proposal was passed. The HUD file was checked, and there is no indication that a change was ever approved. Now, a member challenges the actions of the reduced size Board, wants to run for the extra seat, and raises questions of whether decisions made at meetings where only three Board members were present are valid.

Lessons Learned:

1. Always have a back up copy of all official records. Keep them protected like the Holy Grail. Keep them off-site, even if it means renting space at a storage facility.
2. Always follow through. Adopt the mindset that “It isn’t done until the paperwork is completed.” The press of other business makes it tempting to shuffle papers off into a file, stick it in the drawer and forget about it.
3. Remember that Cooperatives have a perpetual life. That means the records you are responsible for will be important long after you are gone.
4. With all due respect to Board members and Board Secretaries in particular, they come and they go; most are untrained, and cannot be relied upon to keep proper records. It falls to the professionals - the Manager especially - to make sure the records are properly prepared and preserved.

Horror Story # 13: Those Crazy Attorneys

Scenario: The Cooperative Attorney sends sensitive material by accident to a former Board President, who is no longer on the Board. When the recipient is slow to return the materials, the Cooperative Attorney recommends that the Board initiate eviction proceedings - despite the fact that the error was his in the first place.

Lessons Learned:

1. Sometimes even Cooperative Attorneys run amuck and may pursue a personal agenda. This needs to be recognized by the Manager and reported when a proposed action does not pass the “sniff test”.
2. The good ones will not object - and may even encourage - a peer review of a proposed action. Ask an experienced Cooperative Attorney to give a second opinion.

Horror Story #14: The Dissolved Corporation

Scenario: Guess what happens when the State revokes a corporate charter because some one failed to file the required annual report and pay the nominal fee? Given the serious nature of the consequences, I will not discuss the ramifications. Suffice it to say that it is a grave matter.

Lessons Learned:

1. Check with the State agency responsible for keeping such records to verify that the Cooperative is still in active status. That is easy to do in Michigan as it can be done on-line.
2. Make it a regular annual event in your calendar, just to be sure.
3. If it has not been done, run - do not walk - to get the problem fixed; and do it without any fanfare due to the risks involved.

Horror Story #15: The Insurance Does Not Cover this Claim

Scenario: The Cooperative purchased a full insurance packet and dutifully paid the premiums. Later, a suit is brought against the Cooperative alleging a claim for an intentional act, an environmental problem, or an employment-related dispute. The insurance carrier writes a polite letter declining coverage. You are left to defend the suit and pay any settlements or judgments out of Cooperative funds.

Lessons Learned:

1. Insurance is an essential protection whose importance cannot be overstated. It is critical that policies be kept in force at all times; never let there be a lapse in coverage.
2. Once a year, we strongly recommend that you have an audit done of your insurance package by an outside expert, and make a written report to the Board and Manager.
3. The audit should ensure that the coverages are sufficient as to the amount of coverage, the scope of coverage, the deductible. The audit should also verify the quality of the insurance carrier and its ability to pay any claims.
4. The Cooperative Attorney should be involved to evaluate coverage in the “hot spots” of the law. For example, make sure that you have coverage for officers and directors, and for employment claims. Another hot spot is fair housing claims.

Horror Story #16: Unpleasant Surprises in the Chain of Title

Scenario: A Cooperative borrows money and the lender does a title search in preparation of getting a mortgage signed. The title search shows a surprise no one expected. We have seen roads that everyone thought had been deeded over by the developer show up as not belonging to the Cooperative; “lis pendens” notices of

lawsuits filed against Cooperative property even though it dealt with an individual member; and some members have recorded deeds that claim to put all of the Cooperative's property into their own individual trusts.

Lessons Learned:

1. If the Cooperative is going to undertake a loan secured by a mortgage, it is best to do the title search yourselves as soon as possible. If you wait or allow the mortgage company to do it, there may be a lengthy delay to cure the defect that may cost you the loan or increase the interest rate as time passes by.
2. Get help from the Cooperative Attorney. This is a legal issue. It must be handled properly. You do not want to compound the errors.
3. At least in Michigan, title searches are inexpensive. It is easier to cure a problem while the original parties are still alive.

Horror Story #17: HUD Run amuck

Scenarios: Every Cooperative has a story to tell here - where HUD has acted unreasonably such as unilaterally reversing prior positions; by telling you that it will handle the funding levels for reserves on a case by case basis; by not approving budgets until after the year ends; by requiring membership votes for refinancing despite no legal support for that position. The list is endless.

Lessons Learned:

1. Never accept HUD's word as gospel. Challenge it and request citation to authority.
2. When you do challenge HUD, expect the field personnel to react as if you insulted their mothers. Do not hesitate to take it up the ladder, and be prepared to deal with bias and slander. You may have to threaten legal action if it gets too extreme.
3. The Cooperative Attorney, especially if experienced with federal agency procedures, can be an invaluable aid in this endeavor. There are internal investigations that can be initiated by your complaint that will bring the HUD official who has run amuck into scrutiny. Do not succumb to intimidation and harassment. There are remedies to fight back.

Horror Story #18: Lawsuit Spawning Settlements

Scenario: The Cooperative is sued by a member and you dutifully turn it over to the insurance carrier. It picks up the ball and runs with it. The next thing you know, you

receive news that the case has been settled. Suddenly, other members are filing suits for the same claim.

Lessons Learned:

1. Insurance carriers hire the attorneys that pledge to do their bidding; and their goals may not coincide with the Cooperatives.
2. The only way to make sure that the Cooperative is involved in the process and approves any settlement is to have the Cooperative Attorney file an appearance in the lawsuit as “co-counsel” to the insurance attorney. This means that your Attorney will get all pleadings and have a right to be notified of all developments in the court case.
3. Neither the insurance carrier or its attorney will care about the impact on the Cooperative if a case is settled. They will not file countercomplaints and take the offensive. Their job is to settle cases with as little money paid as possible - but that is the problem: they tend to pay even frivolous claims which has the effect of spawning more litigation when other members learn how easy it is.

Horror Story #19: The Propagandist

Scenario: The Board has researched the options available to the Cooperative once the HUD insured mortgage is paid off, and has conducted a members’ informational meeting in advance of a vote of the membership to amend the bylaws to preserve the Cooperative in its present form. Out of the woodwork comes a member who either fails to comprehend the information provided at the membership meeting, or is pursuing a deliberate course of action to lead the membership astray.

Lessons Learned:

1. Some members do not want the truth; rather, they wish to publicize their own propaganda and have no interest in the facts. Most of these types have an agenda that is usually driven by economics. Therefore, if the Cooperative is facing a decision regarding converting to condominium, you should expect these people to initiate a campaign of disinformation.
2. Forget trying to persuade such persons; rather, focus on the average member who is going to be looking for the truth. and will welcome more information.
3. Consider using outside authorities in the legal, finance and management fields to present information since the Cooperatives’ own professionals will often be under attack. Typically, the propagandist will try to discredit everyone within the Cooperative’s administration.

Conclusion

Beyond the specific lessons learned associated with each horror story we discussed - and bear in mind that these are not exhaustive of the challenges that await us in the real world - are some general concepts that are summarized below:

1. “An ounce of prevention is worth a pound of cure”: anticipating and solving problems before anyone recognizes them as pitfalls ought to be every Manager’s goal. Better to be an unsung hero than the person responsible for steering the Titanic.

2. The mark of a great Manager is not measured in terms of pinching pennies, but in realizing a risk and knowing where and when to turn for help.

3. Knowing what you don’t know is a key to success as a Manager. No one knows everything and even brain surgeons do not operate on other parts of the body. Don’t be too proud to ask.

4. Knowing where to find the answers is another element of success. Consider resources such as:

NAHC
Regional Associations
Your Cooperative’s Attorney and Auditor
Other Managers you meet here - the importance of networking
RCM

5. Stay informed since there is one thing that is certain in the law, and that it is changing all the time.