

The Cooperator

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Hiring – and Paying – Contractors

Who Holds the Purse Strings?

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Co-op, condo and HOA living represents a unique social arrangement; it's a paid-for membership club and a home at the same time. Many people enter into this arrangement without a complete understanding of the responsibilities of membership. Others, fully aware of their community responsibility, volunteer to help guide, shepherd and monitor the health and welfare of the community by serving on association or corporation boards.

A typical single-family homeowner employs the skills of various professionals over the course of years to maintain and manage their home; attorneys, accountants, contractors and others as needs arise. The management of a large residential complex, one that may contain hundreds of units, often requires more complex skills. A single-family homeowner might require an attorney to close the purchase or sale of their property, an accountant to do their annual personal income tax, a contractor to repave a driveway or fix a roof. In large residential complexes legal, accounting and other skills often come into play more frequently and in a more complex manner.

Those association or corporation members who volunteer their own time to serve on a board may not themselves have the skills, education, experience and time to provide the expertise for these functions. That's why co-ops, condos and HOAs have managing agents. But sometimes, unfortunately, things can go awry. As much as we don't want to think about

it, and we're not suggesting it happens often, what is a board to do to keep everything on the up and up?

Protecting the Association, Yourself and Your Fiduciary Responsibility

Michael Kim, an attorney who represents co-ops and condominiums and is the principal at Michael C. Kim & Associates, a law firm located in Chicago, suggests the following as a rule of thumb for boards and board members in protecting themselves:

"The board of directors should be actively engaged in the selection of contractors for major capital projects. While it is highly recommended to utilize a consulting engineer/architect to pre-qualify contractors and actually conduct the bid process, if the board does not use an architect/engineer but instead relies upon their management agent, they should discuss and agree with the management agent on the criteria for selecting bidders and the specifications on which the bidders would be submitting their proposals. This ensures uniformity of project descriptions on which bids are to be submitted.

"They also must consider the relevant factors and ranking of such factors to evaluate the bidders/bids, and the screening process to ultimately select the successful bidder," Kim continues. "For example, starting from five bidders, reduce to two bidders to be interviewed, from which one bidder will be selected. A passive board of directors runs the risk that they will effectively 'surrender' the decision-making function to the management agent, which could result in uninformed decision making by the board, or irregularities in the bidding/selection process of which the board would not even be aware. The board could designate one or two of its members to take the lead in such interfacing with management if the entire board is not able or interested in such involvement."

Arlen Lasinsky is a director in the Advisory Services Group of Marcum LLP, a full-service accounting and advisory firm that has an office in Chicago. He and his firm offer forensic accounting services. According to him, "A board of managers is ultimately responsible for

whatever happens. They have the fiduciary duty to do what's proper. They have to do their due diligence." But, he continues, "The board should rely on their management company to refer vendors. The management company and the manager have the connections and the expertise to locate the best vendors for a job. There should be two levels of vetting: first by the management and then by the board." Perhaps most importantly he points out that like all vendors, "the management company is not a substitute for the board. They are a contractor the board hires as well."

Kim concurs with Lasinsky's observations. "As a practical matter," he says, "the board members would likely not have the requisite experience and expertise to perform bid solicitation without professional involvement by either their manager, architect/engineer, or construction manager." But, he points out, "Boards should be proactive in carrying out their fiduciary responsibilities in vetting and selecting contractors. They should ask the following of any potential vendor: do they have any prior experience or relationship or any type of compensation arrangement between the management company and the contractor." Realistically, Kim says, "It is unlikely that a contractor would necessarily 'spill the beans' on any questionable relationship with the management company. In those instances, it may be useful to discuss such concerns with other association boards of directors that have the same management company or previously had that management company and in fact worked with the contractor being recommended."

What If the Worst Happens?

While it is by no means common, fraud and malfeasance can occur. It can occur on the part of a contractor, engineering or architectural consultant, a managing agent or even a board member. In the event your board is concerned that a situation like this occurs, the first thing to do is to contact the association's attorney. The attorney will in turn contact a forensic accountant.

A forensic accountant is an accountant, usually a CPA, who is trained to use accounting skills to investigate fraud or embezzlement and to analyze financial information for use in legal proceedings. Lasinsky explains that forensic accountants generally employ both analytical procedures and interviews to complete their investigations.

Barry Pulchin, a CPA and the director of Forensic Accounting and Valuation Services at Prager Metis' an international accounting firm with offices worldwide, says, "We employ various forensic techniques beyond normal auditing procedures in order to be used in a suitable court of law or public debate." He describes some of these techniques. First, he says, "Were there sealed bids for the job and were the bids sealed and opened at the same time? The likelihood of one company getting jobs over and over again is minimized – if not negated – because the managing agent would have to justify the selection.

"Second, have the vendors been vetted? The board has to do the vetting. The managing agent should not vet the vendors. There must be a separation of responsibilities."

Furthermore, Pulchin suggests there are ways to make sure board members are on the up and up as well. "To check if there are conflicts from board members, we investigate whether anyone on the board is connected to the vendor." Jobs shouldn't be contracted out to a board member's uncle or cousin. Also, "We review contracts for pricing and add-ons. We do comparative pricing. We look at the contract and compare the prices in the contract to the market to see if they are inflated or are consistent with the industry; when they are not, that might clearly indicate a kickback."

Other modes of investigation include viewing canceled checks to make sure they were signed by a board member, and comparing them to invoices for compliance purposes. Bank statements are examined, and canceled checks are reviewed and compared to the books to make sure payees are the same. Payroll is also examined. "In many cases," says Pulchin, "a member of the construction team can be listed on multiple jobs. We spot-check who is on

the job on a daily basis. A contractor could have 10 employees but all of them can't be on multiple jobs at the same time."

Lasinsky makes use of interviewing as part of his forensic investigations. According to him, "You have to take notes. It's very much like police work. The interviewer needs to focus on the interviewee—pay attention to what they say, as well as their body language." He stresses that the interviewer must understand who they are interviewing and have the right questions.

Pulchin points out that "a forensic review is to answer questions – not to make allegations. Based upon forensic finding, if a board believes there was fraud, they should bring in an attorney. Normally an attorney has already been hired." It's usually the attorney who brings in the forensic accountant. "Accountants will want what's called a 'Kovel letter', so that their work is subject to attorney-client privilege." Named after a famous case, *United States v. Kovel*, Pulchin explains that a Kovel letter makes the accountant a subcontractor of the lawyer.

Management's Point of View

Savvy property managers are as much aware of the potentials for fraud and malfeasance as accountants and attorneys. Their professional duty is to their clients, the board of directors of the building or HOA, and their resident constituents. They strive to do the best job they can, and the legal and financial pros interviewed by The Cooperator all indicated that cases of fraud perpetrated by management are rare in their experience.

Managing agents generally seek to work effectively and efficiently with their association clients. This means having the right level of communication, and an understanding of the board's responsibilities versus those of the manager. A board shouldn't micromanage their property manager, nor should they abdicate their responsibilities and leave everything to

him or her. The manager should effectively execute his or her duties so that the board can make educated, effective decisions and choices.

Daniel Valdes, regional director for FirstService Residential in Illinois, explains that like many management firms, his company maintains a business credentials service database “which is full of licensed, insured and vetted vendors that are currently working with them or have worked with them in the past. We reference that database, and it carries manager feedback with notes and references.

“As agents,” he continues, “we want to drive the conversation on which of these can work well for a client based on our prior experience. That’s how you eliminate board members going to Google, or talking to their friends and pulling in vendors with no positive history.”

While the enthusiasm and dedication of board members to their communities may be evident, it is best to leave certain responsibilities to the professionals. Like attorneys and accountants, managing agents are professionals. Valdes says rightly that “you hire a management company to reduce liability, implement best practices and make sure you’re operating the way you should. Having a board member researching vendors opens up liabilities.” There’s not much back story when something goes wrong and all you have is ‘The board member found them on Google’.

In the final analysis, everyone has a job to do in keeping tabs on the purse strings. Ultimately, the fiduciary ‘buck’ stops with the board. They have to do their part by properly vetting contractors and vendors to make sure they are getting reliable, honest service at an acceptable price. They have a support staff: lawyers, accountants and management. And when all four work together, things should work out just fine.