BOARD MEMBER FIDUCIARY DUTY: A Nuts and Bolts Approach

Most board members and community managers have probably heard or been told that a member of the board of directors owes a fiduciary duty to the homeowners association. Most board members and community managers know that fiduciary duty means the board member owes a duty of utmost good faith and fidelity to the homeowners association. However, there seems to be a dearth of information on what fiduciary duty means to board members on a practical, day-to-day basis, as they go about performing their duties. This article will provide a simple, straightforward methodology that board members and community managers can use to insure that the board members satisfy their fiduciary duty obligations to the homeowners association. Perhaps more importantly, following this process will also lead to more thoughtful, reasoned decisions by boards, which will benefit their associations.

What is Fiduciary Duty?

Although fiduciary duty and its application to the boards of directors of homeowners associations is discussed in many court cases, the basic principles are set out in a statute in the California Corporations Code. Section 7231(a) defines "fiduciary duty." It provides: A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

This definition contains three basic prongs which a director must satisfy. First, a director must act in the best interests of the association. Second, a director must act as an ordinarily prudent person would act. Third, a director must act only after reasonable inquiry. We will examine each of these prongs in turn.

1. "The Best Interests of the Corporation"

Although board members are elected to serve on the board of directors, a homeowners association is not a representative form of government. Rather, it is a non-profit corporation and is governed by the rules and principles that govern all non-profit corporations. This distinction has a profound practical impact. A director does not represent a constituency in the manner our elected representatives in government do. Instead, a board member must act in the best interests of the homeowners association as a whole, and can be held liable by any member of the homeowners association for acting in the interests of the minority interests which elected him or her, rather than the interests of the whole association. This does not mean, of course, that reasonable minds cannot disagree on what is in the bests interests of the association. It does mean that favoring a minority interest over the interests of the association as a whole can get a director into trouble.

This is a particularly thorny problem for individuals who are elected to the board of directors by the builder at the outset of a project. Understandably, these individuals feel an obligation to protect the builder's interests, and it is appropriate for the builder elected board members to prevent unwarranted obstructions in the sales of the builder's units. Indeed, this is why the Department of Real Estate permits a builder to own a separate class of membership votes that allows the builder to control the board of directors until the project is 75% sold out. But any obligation to protect the builder's interest in selling the units is overridden by the fiduciary duty which the individual board members owe to the association, regardless of who elected them. See Raven's Cove Townhomes, Inc. v. Knuppe Development Co. (1981) 114 Cal.App.3d 783, 797-801. If any individual board member puts the interests of the builder above those of the association, that board member will be personally liable for any damage caused to the association.

In addition, individuals elected to the board of directors by the builder may not be afforded any of the protections in California Civil Code §5800 that protect volunteer directors and probably are not

covered under the association's directors and officers liability insurance. Thus, board members elected by the builder should be especially assiduous in meeting the three prongs of the fiduciary duty standard.

2. "Ordinary Prudent Person"

The second prong of the fiduciary duty standard is that the director must act as an ordinarily prudent person would act in a like position under similar circumstances. Obviously, this is a somewhat vague standard. How do you judge what some other theoretical person might do under similar circumstances? Fortunately, one clear direction is contained in this standard. A director must act as a "prudent" person would. That means that the director must act in a conservative manner.

Note that the standard is not that of an extremely prudent person or very prudent person, but of an ordinarily prudent person. In other words, although a director must act in a conservative manner, it is not necessary to go overboard and always choose the most conservative alternative in every instance. A director should merely seek to avoid risk where possible while still achieving satisfactory results.

3. "Reasonable Inquiry"

A director must act only after reasonable inquiry. This is the standard which directors violate more than any other. Surprisingly, it is the standard which can be most easily and certainly satisfied.

What does a "reasonable inquiry" mean? It means that you have to ask questions before you make a decision. We see this principle applied in numerous statutes affecting common interest developments. For example, Civil Code §5500 requires that the board of directors review, on at least a quarterly basis, a current reconciliation of the association's bank account and reserve status. Similarly, under Civil Code §5500, the directors are obligated to cause a study of the reserve account requirements every three years and to review that study at least annually. These statutory provisions are merely specific applications of the more general principle that a director, to fulfill his or her fiduciary duties, must make reasonable inquiry.

The Fiduciary Duty Standard in Practice

In order to provide some context for these standards, we will now look a common situation affecting the board of directors of most associations at one time or another construction defects. The issue of construction defects can face any association, regardless of its age. For newer associations, the issue of construction defects usually involves potential claims against the builder. For older associations, a claim for construction defects could involve a roofing contractor who has completed a large re-roofing project, a contractor who replaces or upgrades siding, or perhaps a painter.

The situation usually begins with the most common of complaints there is water leaking into the unit or units of homeowners. When faced with this situation, what should the board of directors do to satisfy their fiduciary obligations? Should the board hire an attorney and file a lawsuit? Should be board simply fix the leak and forget about it? Or should the board avoid spending money at all costs and ignore the situation?

Looking to the standards set forth above, the first question ought to be: What are the interests of the association? In other words, regardless of how the individual board members may feel about the plight of a particular owner, what are the association's responsibilities? If the project is a condominium, and water is leaking in through windows, siding or roofs, it would be likely that it is the association's responsibility to address the problem in some manner. On the other hand, if the project is a planned development in which the owners own the land and the structures, and the association is only responsible for maintenance of common recreational facilities, the association may have no responsibility.

Assuming the association has some responsibility, the next issue is what an ordinarily prudent person would do. Would an ordinarily prudent person ignore water leaking through one window into an owners unit? Probably not. An ordinarily prudent person probably would make arrangements to have the water leak fixed by a local contractor. If two owners experienced water leaks, would an ordinarily prudent person do something different? Still, probably not. However, if four or five unit

owners experienced the same problem, a prudent person would become concerned.

At this point, the board of directors, consistent with their fiduciary obligations, are concerned about water leakage. What does the board do now, remembering, of course, that they must act as reasonably prudent people would act. Here, we turn to the third prong of the fiduciary duty standard-reasonable inquiry. How does a board of directors conduct a reasonable inquiry?

4. “Reasonable Inquiry and the Safe Harbor”

Frequently, when the law imposes obligations on people, the law will also create what is commonly called a “safe harbor.” A safe harbor is typically a set of guidelines that an individual can follow, and, if followed, will protect that person from liability. The fiduciary duty statute includes such a safe harbor. It is contained in §7231(b), which states: “In performing the duties of a director, a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by:

1. One or more officers or employees of the corporation whom the director believes to be reliable and competent in the matters presented;

2. Counsel, independent accountants or other persons as to matters which the director believes to be within such person’s professional or expert competence; or

3. A committee of the board upon which the director does not serve, as to matters within its designated authority, which committee the director believes to merit confidence, so long as, in any such case, the director acts in good faith, after reasonable inquiry when the need therefor is indicated by the circumstances and without knowledge that would cause such reliance to be unwarranted.”

Basically, the safe harbor allows the board of directors to rely on the advice of knowledgeable experts. Turning back to our example, when the board of directors, acting as ordinarily prudent people, developed a level of concern because four or five owners experienced the same leak, the board became obligated to conduct a reasonable inquiry.

Because most directors have very little personal knowledge regarding construction, the board should operate within the safe harbor, and retain some kind of consultant knowledgeable about construction, to make that inquiry.

Here we must add a warning that a director can only rely upon the opinions of experts “as to matters which the director believes to be within such person’s professional or expert competence.” This means that a director cannot act upon the statements of another director who says his brother-in-law used to be involved in construction and says that all windows leak. In such an instance, the board could have no reasonable belief regarding the brother-in-law’s professional or expert competence. A professional community manager can be of a great value in assisting a board in identifying an appropriate professional or expert.

Now, because a consultant has been retained to conduct an inquiry into the nature of this problem, does that mean that the association, acting through its board, can or should pursue litigation? Answering this question is premature. There are a number of other questions which a the board should ask, satisfying its duty of reasonable inquiry, before answering the litigation question.

Once the consultant has conducted a reasonable level of investigation, the consultant should report back to the board. The board should then question the consultant on a variety of topics, including:

1. Does the expert have an opinion as to the cause of the problem?

2. Does the expert have an opinion as to how pervasive the problem might be? (In other words, does this problem affect only four or five owners, or is it likely to affect the whole project?)

3. What is the cost to correct this problem?

4. Does more investigation need to be done in order to answer any of the above questions?

Even after obtaining answers to these questions, the association in still not in a position to decide whether or not to pursue litigation? For example, if the project is fifteen years old and the water leakage relates to the installation of the original roof, any claim may very well be beyond the statute of limitations. The board must, again conducting a reasonable inquiry as a reasonably prudent person would do, consult with its counsel. The same kinds of questions ought to be asked of counsel. (Frequently, the association's counsel is involved in selecting a construction consultant and advising the association in connection with that consultant. Here, we have separated the two inquiries for the purposes of clarifying the process.) The questions to the association's counsel should include:

1. How much is the association likely to recover if it proceeds with litigation?

2. How much is it likely to cost to obtain that recovery? (3) How long is the litigation likely to last?

3. What would be the effect of the litigation on property values?

4. What would be the effect on property values if the association elects not to proceed with litigation?

5. What is the likelihood of success if the association pursues litigation?

6. Are there any statute of limitation issues that would preclude the association from pursuing recovery if it elects to proceed with litigation?

Armed with these answers, both from a construction consultant and the association's counsel, the association is now in a position to make a decision about whether to proceed with litigation or not. It is important to note that in determining whether the board met its fiduciary duty, the board's ultimate decision is far less important than whether the board went through the process outlined above.

The Business Judgment Rule

This brings us to what is known as the "business judgment rule." The business judgment rule, as it pertains to homeowner associations, is set out in Corporations Code 7231(c) and provides:

"A person who performs the duties of a director in accordance with subdivisions (a) and (b) shall have no liability based upon any alleged failure to discharge the person's obligations as a director, including, without limiting the generality of the foregoing, any actions or omissions which exceed or defeat a public or charitable purpose to which assets held by a corporation are dedicated."

Essentially, what the business judgment rule says is that if a director acts in what he or she believes to be the best interests of the corporation, in an ordinarily prudent manner, and after reasonable inquiry, that director is not liable, even if the decision turns out to have been an unwise one. In other words, a court will not allow the association to second guess the decision of its directors as long as its directors have gone through the process outlined above.

The protection afforded by the business judgment rule highlights the importance of documenting in the board's minutes the steps taken by the board to conduct the reasonable inquiry.

For example, following our hypothetical situation in which four or five owners have complained of window leaks, the association might hire a consulting architect to investigate. Based on that investigation, the architect might report back to the board that without opening up the wall, he or she is unable to determine the cause of the water leakage. The architect might also report that in the ten other windows at which he or she looked, at least half of them showed some indication that they might be leaking. Presented with this information, the board should authorize the architect to open

up the walls around two or more of the windows, perhaps one of the windows known to be leaking, and one of the windows suspected to be leaking. The board might also consider a survey of all the members to determine how many owners have an indication of water leakage around their windows.

Once the source of the water leakage and some basic information about how frequently the problem may exist in the project have been determined, the board should determine what the cost of correcting the problem would be. The cost or repair should be compared against information provided by the association's counsel as to what the likely recovery in litigation might be, the cost of obtaining that recovery, and how long the process might take.

The board is now in a position to make an informed decision. As ordinarily prudent people would do, the board has not ignored the problem, but rather taken steps to determine the nature and magnitude of the problem and what the association's options are. The board has made a reasonable inquiry, and it has relied on information supplied to it by individuals whom the board believes to be reasonably knowledgeable and competent within their area of expertise. As long as the board acts in good faith, under these circumstances the board should be well within the scope of the business judgment rule whether or not it elects to go forward with litigation.

Again, the board's consideration of each of the factors outlined above should be reflected in the board's minutes so that the board will be able to establish to any future claimant that it satisfied its fiduciary obligations and the business judgment rule. (The reader should be aware that there are several statutes that set forth specific steps an association considering litigation against a builder must satisfy. A discussion of these statutes and their interplay with the board's fiduciary duty is beyond the scope of this article.)

Conclusion

Although the proceeding discussion uses a hypothetical construction defect problem to illustrate the three prongs of the fiduciary duty standard, the same analysis could be applied to any of a variety of situations which face boards of directors on a regular basis. The important factors to keep in mind are that the board of directors, and each of its individual members, must act in the best interests of the corporation (not in the interests of any minority group of owners who elected them), must act in the same manner as an ordinarily prudent person would act under like circumstances, and must only act after reasonable inquiry. Not only will meeting all three prongs satisfy a director's fiduciary obligations to the association, it is a practical approach to problem solving that will inevitably lead to positive results.

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