"For Whom The Bell Tolls"[1] – Is The Business Judgment Rule Dead?

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INTRODUCTION: THE HISTORY OF THE BUSINESS JUDGMENT RULE

> The relationship between the homeowners association . . . and its board is such a special relationship. The board members of a homeowners association are seldom professional managers, are very often uncompensated and most often are neighbors. **Undoubtedly, the specter of personal liability would serve to greatly discourage active and meaningful participation by those most capable of shaping and directing homeowners' activities.**

(*Jaffe v. Huxley Architecture* (1988) 200 Cal.App.3d 1188, 1193; emphasis added; *see also*, *Matter of Levandusky v. One Fifth Ave. Apt. Corp.* (1990) 75 N.Y.2nd 530, 536-537.)

The Foundation for Community Association Research's *The Community Association's Fact Book 2016* suggests that there are now between 345,000 and 347,000 community associations in the United States. These non-profit associations are governed by **volunteer lay Board of Directors**.[2] In 2016, there were approximately 2,360,000 community association board and committee members.[3] Given the substantial need for volunteer Board members, it is not surprising that state legislatures and judiciaries have recognized the importance of restricting Board member liability so as to encourage participation on such Boards. In addition to these numbers, the trend is to require new

[1] Hemingway, E. (1940). *For Whom The Bell Tolls*. New York, Charles Scribner's Sons.
[2] Most community associations are Not for Profit organizations subject to IRS Code Sections 528 or 501(c)(4) as opposed to Non-Profit 501(c)(3) charitable organizations. The key distinction between these types of associations is that Sections 528 and 501(c)(4) do not have a "public purpose" while the 501(c)(3) does. The community association is a private association without a "for profit" purpose. There are also a number of Cooperative Housing Corporations that were set up decades ago as a for-profit corporation, but their declarations and by-laws establish a not for profit purpose.
[3] The Foundation for Community Association Research's *The Community Association's Fact Book 2016,* "National and State Statistical Review for 2016."

developments be formed as community associations. This trend is a method for governmental entities to shift the cost of infrastructure building and maintenance to private communities. In turn, the demand for volunteer board members continues to grow.

In California, the need to incentivize participation on such Boards has been expressly recognized by its Supreme Court in *Lamden v. La Jolla Shores Clubdominium Homeowners Assn.* (1999) 21 Cal.4th 249, 271, and its legislature in Corporations Code section 5047.5: "It is the public policy of this state to provide incentive and protection to the individuals who perform these important functions." The common law business judgment rule, most commonly associated with Delaware's articulation of the rule, is a judicial construct that as originally constituted is consistent with the above-stated public policy. (*See*, *e.g., Cuker v. Mikalauskas* (1997) 547 Pa. 600, 607.)

The business judgment rule has been employed in the United States as a principle of corporate governance for approximately 160 years.[4]

> "The common law business judgment rule has two components-**one which immunizes [corporate] directors from personal liability** if they act in accordance with its requirements, and another which insulates from court intervention those management decisions which are made by directors in good faith in what the directors believe in the organization's best interest."[5] (*Lee v. Interinsurance Exchange* (1994) 50 Cal.App.4th 694, 714 [ ] citing 2 Marsh & Finkle, Marsh's Cal. Corporation Law (3d ed., 1996 supp.) § 11.3, pp. 796-797.)

(*Lamden v. LaJolla Shores Clubdominium Assn.*, *supra*, 21 Cal.4th at 257; emphasis added.)[6] "The [immunization component of the] business judgment rule grew principally from the judicial concern that persons of reason, intellect, and integrity would not serve as directors if the law exacted from them a degree of prescience not possessed by people of ordinary knowledge." (Arsht, S. (1979) *The Business Judgment Rule Revisited*, Hofstra Law Review: Vo. 8: Iss. 1, Article 6, p. 98.)

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[4] Arsht, S. (1979) *The Business Judgment Rule Revisited*, Hofstra Law Review: Vol. 8: Iss. 1, Article 6, p. 93.

[5] "A hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter's decision can be 'attributed to any rational business purpose.' [Citation omitted.]" (*Unocal v. Mesa Petroleum Co.* (Del. Super. Ct. 1985) 493 A.2d 946, 954.)

[6] *See also*, *Cuker v. Mikalauskas*, *supra,* 547 Pa. at 607–09; *Ski Roundtop, Inc. on Behalf of Ski Yellowstone Inc. v. Hall* (1983) 202 Mont. 260, 273; and *Yates v. Holt-Smith* (Wis. Ct. App. 2009) 319 Wis.2d 756, 770.

Pursuant to the immunization component of the common law business judgment rule, a good faith honest mistake in judgment does not give rise to liability. "[A] director is not liable for a mistake in judgment which is made in good faith and in what he or she believes to be the best interests of the corporation . . . ." (*Barnes v. State Farm Mut. Auto. Ins. Co.* (1993) 16 Cal.App.4th 365, 378; *accord*, *Yates v. Holt-Smith*, *supra*, 319 Wis.2d at 770.) "Good Faith" is defined as:

> ". . . an intangible and abstract quality . . . encompass[ing], among other things, **an honest belief**, the absence of malice and absence of design to defraud or to seek an unconscionable advantage . . . Honesty of intention. . ."

(*Pugh v. See's Candies, Inc.* (1988) 203 Cal.App.3d 743, 763-764, *quoting*, *Black's Law Dict.* (5th ed. 1979) p. 623; emphasis added.)

To effectuate this goal, the common law rule set up a presumption of good faith which placed the burden on the party challenging the decision to demonstrate a violation of the rule. "The business judgment rule is a **presumption** that in making a business decision the directors of a corporation acted **on an informed basis**, in **good faith**, and in the **honest belief** that the action taken was in the best interests of the company." (*Katz v. Chevron Corp.* (1994) 22 Cal.App.4th 352, 1366; emphasis added, citing Delaware authority.)[7]

> The court will presume until shown otherwise, that the directors have in fact exercised, in good faith, their business judgment in what they believed to be the corporation's best interests. . . . [T]he burden of proof or risk of nonpersuasion rests with the plaintiff who attacks a directorial decision.

(Arsht, *The Business Judgment Rule Revisited*, *supra*, at p. 130-131.) "Thus, the party attacking a board decision as uninformed must rebut the presumption that its business judgment was an informed one." (*Smith v. Van Gorkom* (Del. Super. Ct. 1985) 488 A.2d 858, 873[8] citing *Zapata Corp. v. Maldonado* (Del. Supr. Ct. 1981) 430 A.2d 779, 782.)

Under Delaware's articulation of the rule, negligence is not sufficient to rebut this presumption of good faith. "[U]nder the business judgment rule[,] director liability is predicated upon concepts of gross negligence." (*Katz v. Chevron Corp.*, *supra*, 22 Cal.App.4th at 1366-1367, quoting *Aronson v. Lewis* (Del. Super. Ct. 1984) 473 A.2d

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[7] *Accord*, *United Dairymen of Arizona v. Schugg* (Ariz. Ct. App. 2006) 212 Ariz. 133, 140, *citing Blumenthal v. Teets* (Ariz. Ct. App. 1987) 155 Ariz. 123, 128; *Ajay Sports, Inc. v. Casazza* (Colo. App. 2000) 1 P.3d 267, 275; *Whalen v. Connelly* (Iowa 1999) 593 N.W.2d 147, 154; *Becker v. Knoll* (2010) 291 Kan. 204, 208–209; *Crandon Capital Partners v. Shelk* (Or. Ct. App. 2008) 219 Or.App. 16, 31.

[8] Overruled on other grounds by *Gantler v. Stephens* (Del. Supr. Ct. 2008) 965 A.2d 695, 713, fn. 54.

805, 812; *see also*, *Smith v. Van Gorkom* (Del. Super. Ct. 1985) 488 A.2d 858, 873.) Under the business judgment rule, directors "are entitled to immunity from personal liability for acts of ordinary negligence . . . ." (*F.D.I.C. v. Castetter* (9th Cir. 1999) 184 F. 3d 1040, 1044 [discussing California Corporations Code Section 309's codification of the rule].) "This presumption can be rebutted only by a factual showing of fraud, bad faith or gross overreaching." (*Eldridge v. Tymshare, Inc.* (1986) 186 Cal.App.3d 767, 776, *citing Beehan v. Lido Isle Community Assn.* (1977) 70 Cal.App.3d 858, 865.)[9]

> "Bad Faith" is defined as "[t]he opposite of 'good faith,' generally implying or involving actual or constructive fraud, or a design to mislead or deceive another, or a neglect or refusal to fulfill some duty or some contractual obligation, not prompted by an honest mistake . . ., but by some interested or sinister motive[,] . . . **not simply bad judgment or negligence, but rather implies the conscious doing of a wrong because of dishonest purpose or moral obliquity**; . . . it contemplates a state of mind affirmatively operating with furtive design or ill will."

(*Pugh v. See's Candies, Inc.*, *supra*, 203 Cal.App.3d at 763-764; citing Black's Law Dict. (5th ed. 1979) pp. 623 and 127, emphasis added).

Up until recently, California was in accord with Delaware's deferential presumption of good faith limiting not-for-profit homeowners association directors' liability.

> . . . California has adopted the rule that while a condominium association may be liable for its negligence, a greater degree of fault is necessary to hold unpaid individual condominium board members liable for their actions on behalf of the condominium associations.

(*Ritter & Ritter, Inc. Pension & Profit Plan v. The Churchill Condominium Assn.* (2008) 166 Cal.App.4th 103, 121.) Therefore, the party challenging the directors' performance had the burden of showing that the decision either involved a conflict of interest, gross negligence (i.e., failure to exercise even slight care), or was otherwise made in bad faith. (*Katz v. Chevron Corp.*, *supra*, 22 Cal.App.4th at 1366.)

In 2016, the California Fourth Appellate District's decision in *Palm Springs Villas II Homeowners Association, Inc. v. Parth* (2016) 248 Cal.App.4th 268, reversing summary judgment entered in favor of a then eighty-seven (87) year old lay community association volunteer director, did not apply a presumption of good faith and due care

[9] *Accord*, *Koos v. Cent. Ohio Cellular, Inc.* (Ohio Ct. App. 1994) 94 Ohio App.3d 579, 589; *Cuker v. Mikalauskas*, *supra*, 547 Pa. at 607–609.

applied in other California corporate cases. Instead, the Court applied a "standard of reasonable diligence" which placed the burden on the volunteer director to demonstrate reasonable diligence as a condition for asserting the protection of the business judgment rule. (*Id*. at 279, fn. 3.)

The court's ruling in *Parth* was based on language in California Corporations Code Section 7231 that provides that a director cannot be held liable if he/she acts ". . . 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." (Emphasis added.) Section 7231, applicable to non-profit common interest corporations, derives from Corporations Code Section 309 which is California's codification of the common law business judgment rule. (*Briano v. Rubio* (1996) 46 Cal.App.4th 1167, 1177-1179.) The language in Section 309 was based on the Section 35 of the ABA Model Business Corporations Act of 1974.[10]

The reasonable diligence standard adopted in *Parth* arguably abrogates the common law business judgment rule as applied to volunteer directors of common interest developments. Placing the burden on a volunteer lay director to demonstrate reasonableness is not a deferential standard that will encourage "persons of reason, intellect, and integrity" to serve as **volunteer** directors on common interest Boards of Directors. To the contrary, it increases the specter of personal liability for all volunteer directors. The increased risk of liability eventually is likely to reduce the pool of volunteers willing to serve on such Boards thereby frustrating the above-quoted public policy.

Forty-two states plus Washington D.C. have adopted some version of the ABA Model Rule with language similar to that adopted in California.[11] This fact raises the following questions. Does the prevalence of the Model Rule language in the United States signal the end of the business judgment rule's protection for honest mistakes in judgment? Should a volunteer director of a not-for-profit homeowners association be subjected to the specter of negligence liability for corporate acts? If so, what is the potential impact of such liability exposure on the availability, cost, and scope of insurance coverage? How can homeowners associations and their volunteer directors reduce their risk of exposure and still encourage participation?

SECTION 35 OF THE MODEL BUSINESS CODE OF 1974

While the director immunization component of the common law business judgment rule was characterized as a presumption of good faith, the ABA Model Rule

[10] *See*, Marsh et al., *Marsh's Cal. Corp. L.* (2016) DUTY OF CARE, § 11.03 (A), p. 11-26.

[11] See, *Table: State Codification of Business Judgment Rule Based on Language Adopted From The ABA Model Rules*, attached as Exhibit 4.

did not initially expressly address such a presumption. Rather, it framed the business judgment rule as a standard of conduct.

> A director shall perform his duties as a director . . . in good faith in a manner he reasonably believes to be in the best interests of the corporation, **and with such care as an ordinarily prudent person in a like position would use under similar circumstances**.

(Section 35 of the Model Business Code of 1974, attached as Exhibit 1; emphasis added.) The language in Section 35 ultimately became Section 8.30 of the Model Business Corporation Act, entitled "STANDARDS OF CONDUCT FOR DIRECTORS."[12] In 1977, California codified the business judgment rule by adopting Corporations Code Section 309 which was based on the Model Rule in Section 35.

As pointed out in *Marsh's California Corporations*, Section 35

> . . . incorporates the two seemingly contradictory ideas which have been voiced by the courts, i.e., the idea of good faith and acting "in a manner such director believes to be in the best interests of the corporation," which has been the underlying principle of the business judgment rule, and the idea of reasonable care, expressed as "such care as an ordinarily prudent person in a like person in a like position would use under similar circumstances," which has been the underlying principle of the statements that a director is legally required to exercise due care in the performance of his duties. [Citation omitted.]

(Marsh et al., *Marsh's Cal. Corp. L.* (2016) DUTY OF CARE, § 11.03(A), p. 11-26.) *Marsh* goes on to note that although expressed as cumulative requirements, the adoption of such language was not intended to abrogate the common law business judgment rule's protection for honest mistakes made in a good faith attempt to facilitate the best interests of the corporation.

> The Report of the ABA Committee on Corporate Laws with respect to this revised Section 35 of the Model Act stated that it intended by this language to incorporate "the familiar concept that, these criteria being satisfied, a director should not be liable for an honest mistake of business judgment." [Citation omitted.] **While it could be argued that the qualifying phrase, "these criteria being**

[12] *See*, Olson, J. and Briggs, A., *The Model Business Corporation Act and Corporate Governance: An Enabling Statute Moves Toward Normative Standards*, 74 Law and Contemporary Problems 31-44 (Winter 2011), p. 32.

> **satisfied," means that the director must always satisfy the standard of reasonable care imposed and therefore is always liable for negligence, that would make this comment nonsensical. A director *would be* liable for an honest mistake of business judgment, if it was made negligently.** Since this distinguished committee of corporate lawyers presumably meant to say something by this comment, it can only be interpreted as an indication that they, at least, intended to preserve the business judgment rule.

(*Id*., at pp. 11-26 – 11-27; emphasis added.) Yet, some courts and states have interpreted the Model Rule's inclusion of the "due care" requirement in a manner that effectively abrogates the common law business judgment rule's presumption of good faith and informed consent and the presumption's corollary protection for a honest, but negligent, good faith mistake in judgment.

PALM SPRINGS VILLAS II HOMEOWNERS ASSOCIATION V. PARTH

In *Palm Springs Villas II Homeowners Association, Inc. v. Parth*, *supra*, 248 Cal.App.4th at 268, a California Court of Appeal panel reversed a summary judgment entered in favor of an eighty-seven (87) year old lay community association volunteer director and president, Erna Parth, based on the business judgment rule. The Association sued for breach of fiduciary duty based on the following alleged Bylaws violations.

1. Ms. Parth executed a one year contract extension with the Association's then current security company that was not voted on at a noticed Board meeting.
2. Ms. Parth located and referred a roof contractor that ultimately was hired and paid by the Board of Directors to perform a development wide roofing project on a time and materials basis. The Association subsequently contended that the work was deficient and the roofing company was not licensed.
3. Ms. Parth signed, over a four year period, promissory notes securing construction loans totaling over $1.7 million to fund common area roofing, paving and walkway projects. A majority of the Board executed and/or adopted resolutions approving the loans and authorizing Ms. Parth to sign the promissory notes. However, the Association contended that the Bylaws required approval by the members. (The loans were all repaid.)
4. Ms. Parth and a majority of the Board executed a five year landscaping contract extension. However, the Association contended that a Bylaws provision required member approval of a contract with a term over one year.

> 5. Ms. Parth notified the property management company that it had been terminated pursuant to a resolution approved by a quorum of the Board. However, the Association asserted that the meeting at which the resolution was approved had not been properly noticed.

(*Id.* at 271-276.)

Ms. Parth did not have a pre-existing business, familial or social relationship with any vendors who were retained to perform services for the Association while she was on the Board. She did not obtain any pecuniary gain or personal benefit. Therefore, the trial court applied the business judgment rule's presumption of good faith and granted the summary judgment based on the Association's failure to rebut this presumption.

> The court found that Parth had set forth sufficient evidence that she was "disinterested," and that she had "acted in good faith and without willful or intentional misconduct," and "upon the basis of such information as she possessed." The burden shifted to the Association to establish a triable issue of material fact and the court found that the Association failed to satisfy this burden. . . . According to the court, the "gravamen of the [Association's] claim is . . . that Parth repeatedly acted outside the scope of her authority," and that "[t]he problem with this argument is that Parth believed in her authority to act and the need to act, and the [Association] [fails to] offer any evidence to the contrary, except to say that Parth's actions violated the . . . CC&Rs."

(*Id.* at 277-278.) The trial court's grant of summary judgment was based on the business judgment rule's recognition that a disinterested director acting without a conflict of interest cannot be liable for an honest mistake in judgment.

The Court of Appeal, however, did not apply the business judgment rule's presumption of good faith and due care recognized by multiple California cases decided outside of the context of homeowners associations. (See, e.g., *Katz v. Chevron Corp.*, *supra*, 22 Cal.App.4th at 1366.) [13] The Court of Appeal did not point to any facts demonstrating fraud, wilful misconduct, bad faith, or a conflict of interest. Instead, the Court applied a "standard of reasonable diligence" as a prerequisite for the invocation for the protection of the business judgment rule. The Court of Appeal ruled that, regardless

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[13] *See also*, *Everest Investors 8 v. McNeil Partners* (2003) 114 Cal.App.4th 411, 430; *Biren v. Equality Emergency Medical Group, Inc*. (2002) 102 Cal.App.4th 125, 136; *Barnes v. State Farm Mut. Auto. Ins. Co.*, *supra,* 16 Cal.App.4th at 378; *Lee v. Interinsurance Exchange*, *supra*, 50 Cal.App.4th at 715; *Findley v. Garrett* (1952) 109 Cal.App.2d 166, 174-177; *Fornaseri v. Cosmosart Realty & Building Corp.* (1929) 96 Cal.App.549, 557; and *Eldridge v. Tymshare*, *supra*, 186 Cal.App.3d at 776.

of whether Ms. Parth acted in good faith and even if her conduct constituted on honest mistake, "reasonable diligence" is a "'factual prerequisite to the application of the business judgment rule.'" (*Id.* at 277, fn. 3, & 280.)[14]

As mentioned above, the court's ruling was based on language from California Corporations Code Section 7231's codification of the business judgment rule that provides that a director cannot be held liable if he/she acts ". . . 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." (*Id.* at 279-280; emphasis added.) The Court of Appeal went on to hold that the reasonable diligence prerequisite is a fact question that should be left to the trier of fact. (*Id.* at 280-281.) The Court concluded that there were triable issues of fact as to whether Ms. Parth acted negligently regardless of her subjective declarations as to her belief in her authority to act as she did and good faith intent to benefit the Association. (*Id.* at 283-287.)

OTHER STATES' APPLICATION, AND THE EVOLUTION, OF THE MODEL RULE

Although forty-two states plus Washington D.C. adopted some version of the ABA Model Rule incorporating an obligation to exercise directorial discretion with due care and upon an informed basis, not all states interpret such language as the California Court of Appeal did in *Parth*. There is legal authority in at least twenty-two states and Washington D.C. recognizing a presumption of good faith, due care, and/or informed belief. [15] Such a presumption places the burden on the challenging party notwithstanding language in the statute appearing to impose a directorial obligation to act with due care and on an informed basis. Furthermore, there is authority in Georgia, Indiana, Louisiana, and Ohio that, like the Delaware standard, gross negligence or willful misconduct is needed to rebut the presumption of good faith. (See, *Table: State Codification of Business Judgment Rule Based on Language Adopted From The ABA Model Rules* [Ex. 4].) However, a large number of ABA Model Rule states do interpret the duty to act with due care as imposing a negligence liability standard and place the burden on the director to demonstrate the reasonableness of his/her conduct. (*Id.*) Such interpretations gave rise

[14] The trial court distinguished the holding in the *Katz* case that "gross negligence" is required to rebut the presumption of good faith by pointing out that *Katz* was interpreting Delaware law. (*Id.*) Thus, arguably, a paid director of a large for profit Delaware corporation such as Chevron, that operates in California, is entitled to a presumption of good faith but a volunteer director of a non-profit homeowners association does not have such protection.

[15] See, *Table: State Codification of Business Judgment Rule Based on Language Adopted From The ABA Model Rules* [Ex. 4], Alabama, Arizona, Arkansas, Colorado, Connecticut, Georgia, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maryland, Michigan, Missouri, Oklahoma, Ohio, Oregon, Pennsylvania, Tennessee, Utah, Wyoming, and Washington, D.C.

to additional changes to the ABA Model Rules designed to strengthen director's insulation from liability.

In 1998, in an effort to distinguish between director standards of conduct and standards of liability, the ABA modified Section 8.30 of the Model Business Corporation Act, entitled "STANDARDS OF CONDUCT FOR DIRECTORS," and adopted Section 8.31, entitled "STANDARDS OF LIABILITY FOR DIRECTORS."[16]

> Prior to the 1998 amendments, the duty of care was incorporated in section 8.30(a), which stated that "[a] director shall discharge his duties . . . with the care an ordinarily prudent person in a like position would exercise under similar circumstances." [Footnote omitted.] Some courts interpreted this formulation as establishing a simple negligence standard for director liability; members of the Committee were concerned that the statute gave insufficient recognition of the common law business judgment rule. [Footnote omitted.]

(Olson, J. and Briggs, A., *The Model Business Corporation Act and Corporate Governance: An Enabling Statute Moves Toward Normative Standards*, *supra, at* p. 35.) These amendments eliminated Section 8.30(d) "which provided that a director was not liable if he or she complied with section 8.30, and added new section 8.31 to set forth a separate, higher threshold for director liability. [Footnote omitted.]" (*Id.* at p. 36.) Section 8.31 arguably recognizes the presumption of good faith and due care by placing the burden on the challenging party to establish that the director breached his/her duties.[17] As opposed to the original version of Section 8.30, section 8.31 was not intended to codify the business judgment rule. "Nonetheless, by adopting new vocabulary and distinguishing between standards of conduct and standards of liability, the Committee appears to have intended to **increase the level of director insulation from liability** by encouraging courts to take an expansive view of the protections offered by the rule." (*Id.*; emphasis added.) Ten states (Connecticut, Idaho, Iowa, Louisiana, Maine, Mississippi, Nebraska, South Dakota, West Virginia, and Wyoming) and Washington, D.C. have adopted statutes based on Section 8.31's Standards of Liability for Directors.[18]

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[16] *See*, Olson, J. and Briggs, A., *The Model Business Corporation Act and Corporate Governance: An Enabling Statute Moves Toward Normative Standards*, *supra, at* pp. 35-36.

[17] *See*, ABA Model Business Corporation Act, §§ 8.30 & 8.31, and ABA Model Nonprofit Corporation Act, §§ 8.30 & 8.31, attached as Exhibits 2 and 3, respectively.

[18] See, *Table: State Codification of Business Judgment Rule Based on Language Adopted From The ABA Model Rules* [Ex. 4].

IMPACT OF A NEGLIGENCE LIABILITY STANDARD AND/OR ELIMINATION OF THE PRESUMPTION OF GOOD FAITH

The focus on "due care" and "reasonableness" connotes a determination of negligence. (*See*, *e.g., Hernandez v. Badger Constr. Equip. Co.* (1994) 28 Cal.App.4th 1791, 1831.) In *Parth*, the Court of Appeal acknowledges that it adopts a negligence prerequisite but claims that "there is 'no conflict' between the business judgment rule and negligence." (*Supra*, at 287-288.) Calling "reasonable diligence" a "prerequisite" to the business judgment rule is a misnomer. A "standard of reasonable diligence" usurps the business judgment rule as the standard of liability for directors.

Standards of negligence and good faith are different concepts. One is a subjective belief (good faith), whereas the other (negligence) is a hindsight objective analysis as to what a reasonable person would do under such circumstances. (*Hernandez v. Badger Constr. Equip. Co.*, *supra,* 28 Cal.App.4th at 1831.) As pointed out in *Marsh's California Corporations*,

> . . . the concept of **negligence**, which is the opposite of due care, and the concept of **dishonesty or bad faith**, which are opposites of honesty and good faith, **are not the same**, and no amount of assertion that there is "no conflict" will make them so.

(Marsh et al., Marsh's Cal. Corp. L. (2016) DUTY OF CARE, § 11.03(A), p. 11-16; emphasis added.)

The Legislative Committee Comments to California Corporations Code Section 309(a) reflects that "it is the intent of the draftsmen of this provision . . . that . . . **a director should not be liable for an honest mistake of business judgment**." (Emphasis added.) The authors of *Marsh's* note that construing the business judgment rule statutes, Corporations Code Sections 309 and 7231, as imposing a "standard of reasonable care" prerequisite to the business judgment rule effectively abrogates the business judgment rule as a director could be liable for negligence. (*Id.* at 11-26.1 – 11-27.) "A director *would* then be liable for an honest mistake of business judgment." (*Id.*) However, protection from an "honest mistake in business judgment" is the very crux of the business judgment rule.[19] (*See, Biren v. Equality Emergency Med. Group, Inc., supra*, 102 Cal.App.4th at 136-137; *Marsh's Cal. Corp. L.,* § 11.03(A), p. 11-26.1-11.27; *see also*, *Yates v. Holt-Smith*, *supra*, 319 Wis.2d at 770.)

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[19] At least one commentator already recognized the inconsistency of *Parth's* "standard of reasonable diligence" with the business judgment rule. "Assuming that Parth was negligent for not doing more, the business judgment rule should still have applied for Parth's mistaken, yet good faith acts." (Ram, *A cautionary tale of California's business judgment rule*, Daily Journal (July 12, 2016) p. 8.)

One of the impacts of abrogating the business judgment rule's presumption of good faith and due care is that a negligence standard will make it virtually impossible to summarily adjudicate any claim against a volunteer director short of trial. As the *Parth* court noted, such a negligence determination ordinarily "raises various issues of fact" that generally should be left to the trier of fact. (*Supra*, at 280-281.) The corollary effect of reducing the ability to summarily adjudicate a director claim is that it will increase the cost to litigate.

Also placing the burden on the director to prove reasonableness, as opposed to the challenging party, is a favorable plaintiff's standard. As such, it may encourage litigation against volunteer directors. Promulgation of litigation is contrary to public policy supporting many deferential standards accorded to the management of homeowners associations. For example in *Lamden v. La Jolla Shores Clubdominium Homeowners Assn.*, *supra*, 21 Cal.4th at 271, the California Supreme Court adopted a Rule of Judicial Deference standard governing the review of community association's maintenance decisions. In doing so, the Court recognized the importance of reducing litigation in encouraging volunteer participation in the governance of these community associations.

> A deferential standard will, by minimizing the likelihood of unproductive litigation over their governing associations' discretionary economic decisions, foster stability, certainty and predictability in the governance and management of common interest developments. **Beneficial corollaries include enhancement of the incentives for essential voluntary owner participation in common interest development governance and conservation of scarce judicial resources.**

(Emphasis added; *cf.*, *Hollywood Towers Condominium Ass'n, Inc. v. Hampton* (2010) 40 So.3d 784, 787-788; *Weldy v. Northbrook Condominium Ass'n* (2006) 279 Conn. 728, 734.)

Similarly in *Nahrstedt v. Lakeside Village Condominium Assn.* (1994) 8 Cal.4th 361, 380, the California Supreme Court recognized the important public functions that homeowners associations and their volunteer directors play in the maintenance and operation of such common interest developments. The Court acknowledged that these important functions were facilitated by a deferential standard of review of governing documents that discouraged and reduced the cost of litigation.

> There is an additional beneficiary of legal rules that are protective of recorded use restrictions: the judicial system. Fewer lawsuits challenging such restrictions will be brought, and those that are filed may be filed more expeditiously, if the rules courts use in evaluating such restrictions are clear, simple, and not subject to exceptions based on the peculiar circumstances or hardships of

> individual residents in condominiums and other shared-ownership developments.

(*Nahrstedt*, *supra*, 8 Cal.4th at 383; *Levandusky* v. *One Fifth Avenue Apartment Corp*., supra, 75 N.Y.2d at 537-540.)

A negligence standard is amorphous and unpredictable. It must be decided on a case by case basis as what one jury considers to be reasonable conduct, another jury may find unreasonable. Virtually every act a volunteer director takes is subject to a negligence claim based on hindsight analysis. The business judgment rule's presumption of good faith and due care is more predictable. A director cannot be liable for an "honest mistake" whether negligent or otherwise. If the director acts without a conflict of interest with an intent to facilitate the interests of the corporation, he can be relatively certain under such a standard that he cannot be held liable for his service to the corporation.

According to *Marsh's*, *supra*, at 11-15, cases in the United States holding directors liable for "mere negligence" are "virtually nonexistent." *Marsh's* authors attribute such a fact to the court's application of business judgment rule protection notwithstanding purported directorial "due care" standards of conduct. (*Id.*) The prevalence of the negligence standard and the abolition of the business judgment rule presumption suggests that it is only a matter of time before a volunteer director is held liable for negligence. Given uncertainties as to insurance coverage,[20] a publicized judgment certainly will increase director concerns over the specter of personal liability for all volunteer directors and volunteer committee members. It, also, may place a chilling effect on board members in how they approach their position. The Board may be reluctant to make decisions beneficial to the Association out of fear of incurring personal liability.

Whether you believe the abrogation of the business judgment rule is a good development or not may depend on whose ox is being gored. Such a development is likely to discourage many of those best qualified to serve as directors to refrain from doing so thereby potentially reducing stability in association management. On the other hand, the reduced obstacles to liability make it easier for a homeowners association to potentially access its Directors & Officers insurance to indemnify it for negligent directorial decisions. Even if one believes that the director, rather than the Association, should bear the risk of negligence, there remains a potentially significant impact on the availability, cost, and scope of obtaining applicable insurance.

[20] For example, many D & O policies include insured versus insured exclusions. (*See*, LaCroix, *The D&O Diary,* "Executive Protection: D&O Insurance Policy Exclusions (Oct. 19, 2010).)

IMPACT ON THE AVAILABILITY, COST, AND SCOPE OF COVERAGE FOR DIRECTORS AND OFFICERS INSURANCE

The keystone presumption underlying the Director & Officer's ("D&O") policy and rating is the business judgment rule's presumption of good faith that the volunteer board of unit owners has fulfilled its fiduciary obligation in acting in the best interest of the community association for which it voluntarily serves, and putting the association's interest above the individual board member(s) interest. It is the individual or entity that is challenging the board's conduct or decision that has the burden to refute this presumption.

The more than 345,000 community associations in the United States are in the normal course Not for Profit Mutual Benefit Corporations. The associations are budget driven entities that are funded by the unit owners who are mandatory members of the associations. The funds to operate the association from landscaping to capital improvements to insurance are paid by the unit owners through assessments. Many of these costs are for infrastructure items that have been passed to these 345,000 plus associations by various local and state governmental agencies. This transfer of municipal functions is particularly significant in California as a result of the state's economy. It does not appear that this arrangement of transferring the cost of infrastructure will be changing any time soon. As a result, although the primary obligation is not for those managing the association to save money, that is in reality a key focus.

The associations are managed by "volunteer" unit owners, many of whom have no experience or training in the management of the association. Although the board members may retain professional community association managers and use community association experts in various decisions, this is again a lean and mean operating entity and its membership will challenge and question every penny that is spent and each decision that the board makes.

The volunteer board members of each community association are charged with the duty to manage the risk of the community association. In consideration for their volunteer work for the association, which often turns into a non-paid full time endeavor, the association governing documents will include an agreement to indemnify the board member(s) if he or she is challenged for the work done in the capacity as a board member. An exception to this indemnification obligation is where the board member is found to be "grossly negligent" or "willful" in his or her conduct.

The purpose of D&O coverage for the community association is to fund the association's indemnification agreement with board members and officers. As indicated, these associations are budget driven entities and one item they do not budget for, nor are they equipped or qualified to budget for is this potential indemnification obligation. Accordingly, D&O policies must be purchased to provide the best possible protection for directors and officers. Without this protection, it will be difficult to recruit the best people to volunteer for the board and help effectively manage the community association assets.

The D&O policies that provide the basic necessary coverage are liability policies and in the community association arena, these are duty to defend policies with defense outside the limits in most cases. Accordingly, if there is a $1,000,000 limit of liability, and it costs $2,000,000 for defense fees and costs, the insurance carrier will be responsible for the total amount. These policies are "defense cost" centric cases. In addition to the defense outside the limits, the definition of insured is very broad in these policies and does not just include directors and officers, but extends to employees, non-board member committee members, the association itself, community association managers and the spouses or partners of board members when they are sued for the board members conduct.

In California as well as the remainder of the states, program managers and carriers have relied on the business judgment rule presumption. If you asked board members, community association managers and other community association professionals, regardless of the state they reside in, when asked, they will say their conduct and decisions as a board member are protected by the business judgment rule.

This business judgment rule presumption is a major factor in the underwriting and rate structure of the policy premiums. The insurance community has relied on the sanctity of the business judgment rule in the context of common interest developments and the ability of cases to be resolved expeditiously by demurrer, summary judgment motions, or other early dispositive motions. Community association members and others very often dislike board decisions and pursue a claim against the board members and often the association itself. Where the community association is managed by an independent management company, the community association manager is often included in the claim. The management agreements almost always have indemnity agreements as well requiring the association to defend and indemnify the manager. As a result, the D&O policy is used to fund that indemnification obligation as well.

There are many unintended consequences of expanding volunteer directors' exposure, and hence the carrier's exposure, by abrogating the business judgment rule. It may force insurance carriers to exit this niche or significantly increase the cost of insurance and/or reduce the breadth of coverage. It will force insurance carriers to significantly increase deductibles which the associations will have to absorb. In some extreme situations it could force associations to forgo insurance due to cost and require the unit owners to fund the indemnification out of the association's assets, including any reserve or capital improvement funds, increased assessments or special assessments.

Furthermore, increased litigation costs associated with having to try virtually every claim that is not settled may impact the cost and/or ability of Association's to secure Directors' and Officers' liability insurance. Many insurance carriers have left the State of California, especially in the employment liability sector. Due to the increase in community association D&O claims, carriers are looking at pulling out of the state. Adopting a directorial negligence liability standard and eliminating the business judgment rule's presumption of good faith and due care, will give many carriers an

excuse to do just that. The lack or scarcity of willing D&O insurers will impact every demographic, from exclusive community associations with very expensive homes and condominiums to the smallest of community associations in much more economically challenged areas.

RECOMMENDATIONS TO ADDRESS IMPACT ON LIABILITY AND INSURANCE AVAILABILITY

In a world where the director potentially can be held liable for negligence, such directors will need to be extremely careful so as not to inadvertently expose themselves to liability. The directors need to thoroughly and routinely review their governing documents. The directors can, and should, make use of and rely on experts such as attorneys, managers, insurance professionals and accountants. (Such reliance undoubtedly will result in another unintended consequence of a negligence standard, increased operating and management costs.) Care should be taken to document such reliance.

Directors should review the governing documents to determine if there is an exculpatory clause limiting their liability. If so, the directors need to review and understand the scope, limitations, and conditions of the clause. If the governing documents do not contain an exculpatory clause, the Association should consider adopting one in order to encourage director participation.

The Association needs to make sure that it procures and maintains the best available insurance coverage for the myriad types of potential claims that vex volunteer directors. Insurance coverage is not the budget item that the board should attempt to cut corners on to save money. There are plenty of other budget line items where the association can shave costs.

Some states have statutes limiting volunteer director's liability under certain circumstances. For example, in California, a volunteer director or officer cannot be held personally liable in excess of insurance coverage "to any person who suffers injury, including, but not limited to bodily injury, emotional distress, wrongful death, or property damage or loss as a result of the [director or officer's] tortious act or omission" provided his/her conduct was not willful or grossly negligent, within the scope of his/her duties, in good faith, he/she does not own more than two units, and the Association maintains insurance at the levels specified in the statute. (California Civil Code § 5800(a).)[21] In California, and states with similar statutes, the Boards must remain diligent and ensure that the Association's insurance coverage meets the statutory mandated limits to avoid subjecting its directors and officers to a direct action to personal liability exposure for negligence.

[21] The Association must maintain D & O and General Liability Policies with $500,000 coverage if less than 100 units in the project, and $1,000,000 coverage if more than 100 units. (California Civil Code § 5800(a)(4).)

Directors who are willing to serve in this *Brave New World*[22] of potential liability may want to investigate the availability of additional coverage that may exist in their own umbrella policy for exposure as a volunteer board member in a non-profit or not for profit organization.

[22] Huxley, A., (1932) *Brave New World*, New York: Harper Brothers.