Fiduciaries-Everything You Thought You Knew?!

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I. <u>INTRODUCTION</u>

There is a common assumption that a homeowners association, its officers, and its directors occupy a fiduciary relationship with the association membership. Often such an assumption is incorrect.

> "[T]he relationship between the individual owners and the managing association of a common interest development is complex." . . . On the one hand, each individual owner has an economic interest in the proper business management of the development as a whole for the sake of maximizing the value of his or her investment. In this aspect, the relationship between homeowner and association is somewhat analogous to that between shareholder and corporation. On the other hand, each individual owner, at least while residing in the development, has a personal, not strictly economic, interest in the appropriate management of the development for the sake of maintaining its security against criminal conduct and other foreseeable risks of physical injury. In this aspect, the relationship between owner and association is somewhat analogous to that between tenant and landlord.

(*Ostayan v. Nordhoff Townhomes Homeowners Assn., Inc.* (2003) 110 Cal.App.4th 120, 126-127 [citations omitted].)

As a result of this dichotomy, whether a fiduciary duty is triggered in a homeowners' association context may depend upon the obligations attempting to be discharged. Justice Frankfurter identified the problem of defining a fiduciary best in the often-quoted passage from *SEC v. Chenery Corp*. (1943) 318 U.S. 80, 85–86:

> But to say that a man is a fiduciary only begins the analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?

This program attempts to answer these questions. What follows is an in-depth review and analysis of when associations, directors, and officers are actually acting as fiduciaries, and the corresponding duty, standard of care, and liability that arises from common association functions.

II. FIDUCIARY DEFINED?

A. General Definition

What is a fiduciary duty and when does the duty apply? We begin with consideration of the basic definition of a director's fiduciary obligation to the association, its members, and others.

Black's Law Dictionary[1] defines the term "fiduciary" as "a person having duties involving good faith, trust, special confidence, and candor towards another," and "fiduciary duty" as "a duty to act for someone else's benefit, while subordinating one's personal interests to that of the other person." In California, the basic definition of a corporate director's fiduciary's obligations is found in section 7231(a) of the Corporations Code, which 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.

Similar definitions are also found in most states. Forty-two states and the District of Columbia have adopted, at least in part or in a modified form, the ABA Model Business Corporation Act (MBCA).[2] MBCA section 8.30 defines a corporate director's duty of care. MBCA section 8.42 imposes substantially the same duty of care on corporate officers possessing discretionary authority. These two sections focus on the manner in which directors and officers perform their duties, not the correctness of their decisions. Both sections are based on the idea that directors and officers make discretionary decisions for the benefit of their association and members. Directors and officers are required to perform their duties in good faith, with the care of ordinarily prudent persons in like positions and in a manner that they believe to be in the best interest of the association. Nevertheless, as discussed in more detail later, under what is commonly referred to as the "business judgment rule," directors generally are not responsible for simply having bad business judgment. Through time courts have defined the scope of a director's duty of loyalty and care to an association through case law and the theory or philosophy of law, rather than by statute. More recently, a director's duties are often further defined through legislation; however, the courts continue to help define and refine the scope of a director's obligations.

Based on such law, the association's officers, directors, and arguably managers owe at least some fiduciary duties, which will be enforced by the court, to the association, and, through the association, to its members. State law generally delineates that duty. However, we find that

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[1] Black's Law Dictionary abridged Sixth Edition.

[2] T. Ware and J. Meskin, *"For Whom The Bell Tolls" – Is The Business Judgment Rule Dead?, 2018* Community Association Law Seminar, Table: State Codification of Business Judgment Rule Based on Language Adopted From The ABA Model Rules (Exh. 4).

the precise definition of that duty is anything but clear and can vary based on the role that either the board of directors or individual directors are carrying out on behalf of the association.

B. Law vs. Equity?

The principal role of a director is to serve in a position of trust that makes discretionary decisions on behalf of an association and its members. This role of trust is the expectation that directors will act for the benefit of someone else. Trust also has a particular meaning in the law, denoting an arrangement by which land or other property is managed by one party, a director, on behalf of other parties, i.e., members of the director's association. Fiduciary duties are enforced by law and imposed on persons in certain relationships requiring them to act entirely in the interest of another, a beneficiary, and not in their own interest. Key to this duty is the role that directors play when making discretionary decisions.

The obligations of a fiduciary that we discuss today, the origins of which are found in the English legal system, as it developed over the last 600 years, set the structure and character of our modern law. Common law, the law applied in England's central royal courts, was the dominant feature of this legal system. The long-understood story is that English common law in its formative centuries was unacquainted with "trust" as a legal device or, even as a practical matter, the ability of people to be trustworthy. Fiduciary duties grew up outside the common law in the separate courts of chancery with the law of trusts and trustees, only being incorporated a century and a half ago with the fusion of the courts of law and the courts of equity. Accordingly, we find that the word fiduciary has its origins in Latin, as courts of chancery being courts of the church used Latin in their pleadings. Today, we have a system that can be described as a hybrid where the courts apply both equity and law when deciding cases.

C. Right to jury? Courts sitting in equity? No right to a jury.

What no jury? This is often the response of a plaintiff upon discovering that the court, but not a jury, will decide the issue of whether a director breached his/her fiduciary duty to an association or member. Why? Because the obligations of trust and the resulting fiduciary duty evolved from the court of chancery and these principles do not exist under common law.

Under both Delaware law and California law, entitlement to a jury trial depends on whether an action is legal or equitable. (*Park Oil, Inc. v. Getty Refining & Marketing* (Del.Supr.1979) 407 A.2d 533, 535; *Southern Pac. Transportation Co. v. Superior Court* (1976) 58 Cal.App.3d 433, 435.) In Delaware, the equity jurisdiction of the Court of Chancery, as it existed prior to the separation of the American colonies, determines whether an action is legal or equitable. (*Du Pont v. Du Pont* (Del.Supr.1951) 85 A.2d 724, 727.) In California, the right to a jury trial is coextensive with that right as it existed in 1850 under English common law. (*C & K Engineering Contractors v. Amber Steel Co*. (1978) 23 Cal.3d 1, 8.) To ascertain whether a party is entitled to a jury trial, the court must first classify the causes of action. A claim for breach of fiduciary duty brought under most corporate legal schemes, in which the plaintiff seeks damages, is generally an equitable claim. Nevertheless, an attorney must begin with a description and analysis of the claim, then return to the issue of its classification as legal or equitable, to determine whether a party is entitled to a jury.

The California Supreme Court in addressing this issue has determined:

> A jury trial must be granted where the gist of the action is legal, where the action is in reality cognizable at law. On the other hand, if the action is essentially one in equity and the relief sought depends upon the application of equitable doctrines, the parties are not entitled to a jury trial. Although we have said that the legal or equitable nature of a cause of action ordinarily is determined by the mode of relief to be afforded, the prayer for relief in a particular case is not conclusive. Thus, the fact that damages is one of a full range of possible remedies does not guarantee the right to a jury.

(*C & K Engineering Contractors*, supra, 23 Cal.3d at 9, [citations and internal quotation marks omitted].)

In *C & K Engineering*, the court found that the parties were not entitled to a jury trial even though the plaintiff's suit sought damages. The lawsuit was based entirely on the equitable doctrine of promissory estoppel. (*C & K Engineering Contractors*, supra, 23 Cal.3d at 5.) The fact that “[b]oth historically and functionally, the task of weighing such equitable considerations is to be performed by the trial court, not the jury” was critical to the court's rationale. (*Id.* at 11.)

Based on *C & K Engineering*, a claim for breach of fiduciary duty by trust beneficiaries concerning the management of a trust was found equitable because it was based on an equitable right. (*Van de Kamp v. Bank of America* (1988) 204 Cal.App.3d 819, 865.) The fact that the plaintiff sought damages did not alter the court's conclusion since "[a]n action is one in equity where the only manner in which the legal remedy of damages is available is by application of equitable principles." (*Ibid.*)

The nature of the cause of action and whether it is predominantly based on equitable principles are crucial determinations in a court's decision on whether a party is entitled to a jury. The fiduciary duty of a controlling shareholder or director to a minority shareholder is based on "powers in trust." (*Jones v. H.F. Ahmanson & Co.* (1969) 1 Cal.3d 93, 107.)

> For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary.... Where there is a violation of these principles, **equity** will undo the wrong or intervene to prevent its consummation.

(*Id.* at p. 109 [quoting *Remillard Brick Co. v. Remillard-Dandini Co.* (1952) 109 Cal.App.2d 405, 420–421] [emphasis added].)

Trust relationships are premised on equitable principles. (See *McMahon v. New Castle Associates* (Del.Ch.1987) 532 A.2d 601, 604; *Jones v. H.F.* 1556 *Ahmanson & Co.*, supra, 1 Cal.3d at p. 107). In addition, "entire fairness" is about adjusting equities. (See *C & K Engineering Contractors*, supra, 23 Cal.3d at 11, [court is required to exercise equitable principles when it adjusts rights, equities, and interests].) The test requires weighing various considerations to reach a just result. (*Cinerama, Inc.*, supra, 663 A.2d at 1162–1163 [explaining entire fairness test].) That standard illustrates a court's equitable power to weigh various considerations in order to reach a just result. The sole method of obtaining damages in this case is by application of equitable principles. It follows that an action for breach of fiduciary obligations, whether damages are sought, is properly classified as an equitable action.

Under these principles, a party is not entitled to a jury trial in an equitable action. (*Southern Pac. Transportation Co.*, supra, 58 Cal.App.3d at 435.) Accordingly, a party who sues for breach of fiduciary duty arguably is not entitled to a jury trial. (*See*, *Interactive Multimedia Artists, Inc. v. Superior Court* (1998) 62 Cal.App.4th 1546, 1548.)

III. WHO IS A FIDUCIARY?

In the context of homeowner associations, two main groups of actors will typically owe a fiduciary duty to the association: directors and officers, and managing agents. Other fiduciaries include developer representatives, committee members, and in some cases individual members in various circumstances.

A. Directors & Officers

The most easily identified fiduciaries in a homeowners association context are the directors. "[I]t is well settled that directors of nonprofit corporations are fiduciaries." (*Raven's Cove Townhouse, Inc. v. Knuppe Dev. Co.* (1981) 114 Cal.App.3d 783, 799.) These persons serve as decision makers and are granted discretionary decision-making authority under both an association's governing documents and the law.

Courts have noted that the duty of undivided loyalty (see Scott, The Fiduciary Principle, 37 Cal.L.Rev. 539) applies when the board of directors of an association considers maintenance and repair contracts, the operating budget, the creation of reserve and operating accounts, etc. Because the directors exercise discretion on behalf of the association, they are held to the highest standard. Further, directors, whether they are owners or developers, are responsible for the money and property of others. Therefore, the directors serve in a "fiduciary capacity" with a duty to act for the benefit of others and not for themselves.

Fiduciary duties often extend to corporate officers as well as directors. "The business and governmental aspects of the association and the association's relationship to its members clearly give rise to a special sense of responsibility upon **the officers and directors**.... This special responsibility is manifested in the requirements of fiduciary duties and the requirements of due process, equal protection, and fair dealing." (12 Wake Forest L.Rev. 915, 921; emphasis added.)

B. Managers, Agents

Managers, who are generally considered agents of an association, owe fiduciary duties to the association. As stated above, a fiduciary duty is a legal duty to act solely in another party's interest. Managers are bound by contract and principles of agency to act in the best interest of the association that they manage. Managers when acting on behalf of the association owe this duty and are fiduciaries to their principal, the association.

Such obligations are often codified. For example, California Civil Code sections 5375(e) and 5375.5 require managers to disclose conflicts of interest. Accordingly, we find that the type of role the manager is acting in will determine whether they are in fact a fiduciary.

The contract between an association and its managing agent will typically provide that the association will indemnify and hold the manager harmless for ordinary negligence when attempted to discharge its contractual managerial duties. As a consequence, a corollary contractual obligation is created prohibiting the manager from acting outside of the authority bestowed and entrusted by the Board to the manager. In other words, the manager acts as a fiduciary to the Board to the extent that he/she aids the Board in carrying out its fiduciary duties.

C. Others? Developers, Committee Members, and the Association Itself

When associations are formed, their directors are often the employees of, or otherwise associated with, the development entity. Developer agents and employees who serve as association directors, may not make directorial decisions that benefit their own interests at the expense of the association and its members (*cf. Northridge Coop. Sec. No. 1 v. 32nd Ave. C. Corp.* (1957) 2 N.Y.2d 514; *Shore Terrace Cooperative, Inc. v. Roche* (1966) 25 A.D.2d 666, 667; *Ireland v. Wynkoop* (1975) 36 Colo.App. 205, 217). When a developer dominates the association and controls those that serve on the board, or where the methods of control by the membership are weak or nonexistent, in these cases courts have found that closer judicial scrutiny is appropriate, as the principles of fiduciary duty established with corporations must exist for holding those exercising actual control over the association to a duty not to use their power in such a way as to harm unnecessarily a substantial interest of the owners within the association. (12 Wake Forest L.Rev. 915, 923.)

When the developer controls the seats on the board and is simultaneously selling separate interests, the developer must wear the "board hat" separate from the "developer hat." "In most jurisdictions, the developer is a fiduciary acting on behalf of unknown persons who will purchase and become members of the association (*Florida Condominiums Developer Abuses and Securities Law Implications*, 25 U.Fla.L.Rev. 350, 355)." (*Raven's Cove Townhouse, Inc. v. Knuppe Dev. Co.*, *supra,* 114 Cal.App.3d at 799.) Thus, the developer directors, like directors after the development entity no longer controls the association, owe a fiduciary duty to owners, including those owners that will acquire a future interest in the association. (*Id.*) In other words, developer representatives may not abuse or exploit their board positions to benefit their personal economic or other interests, regardless of the role they perform. "The subject of fiscal responsibilities, e.g., 'lowballing' failure to pay assessments on unsold units, the failure to enforce the obligation to pay, is one of the areas of great developer exposure." (*Id.*)

Accordingly, it is a matter of necessity for good management and the fiduciary duty to keep adequate books, records, and minutes on behalf of the association. (See also *Self-Dealing by Developers of Condominium Project as Affecting Contracts or Leases with Condominium Association*, 73 A.L.R.3d 613.) As a consequence, the failure of directors to exercise supervision so as to permit mismanagement or non-management is an independent ground for the breach of fiduciary duty especially during the period when the developer and its employees maintain significant and direct control.

The same is true for architectural committees when deciding on an owner's architectural application. The California case of *Cohen v. Kite Hill Community Association* (1983) 142 Cal.App.3d 642, 655, holds that **a homeowners' association itself owed a fiduciary duty** to exercise in good faith its authority to approve or disapprove an individual homeowner's construction or improvement plans in conformity with the Declaration of Covenants and Restrictions. According to the *Cohen* holding, the architectural committee's decision cannot be "arbitrary nor in violation of the Restrictions." In addition, the *Cohen* case also holds that the association's architectural committee, in reviewing an architectural application, also owes a fiduciary duty to the adjoining property owners to act in good faith and to avoid arbitrary action. Thus, the association is faced with "competing fiduciary duties." Not only is the duty of the architectural committee owed to the association, but it is also owed to individual homeowners. We find that these duties are based in large measure on the role that the fiduciary is performing on behalf of the association.

D. Fiduciary Duty May Depend on Function or Obligation Being Exercised.

It is wise to always assume that directors and officers owe fiduciary duties to the Association entity. However, whether an officer, director or the Association itself owes a fiduciary duty to a member may depend on the nature of the duty being discharged. In the seminal California Supreme Court case of *Frances T. v. Village Green Owners Assn.* (1986) 42 Cal.3d 490, the Court held that a homeowners association and its directors do not always occupy a fiduciary position vis-à-vis the association membership. Rather, the court noted that the scope of its obligation depends upon the nature of the duty it is attempting to discharge.

1. Maintenance—Landlord Obligation Not A Fiduciary One?

In *Frances T.*, a condominium unit owner sued her homeowners' association and its volunteer Board of Directors for damages arising out of her being raped and robbed in her condominium unit. The plaintiff asserted causes of action for negligence, breach of contract (Declaration of Restrictions), and breach of fiduciary duty. (*Id.* at 495.) The trial court sustained demurrers to each of these causes of action. (*Id.*) The Supreme Court reversed the demurrer rulings with respect to the negligence cause of action, but upheld the ruling with respect to the breach of contract and breach of fiduciary duty causes of action. (*Id.* at 498, 512-514.)

Pursuant to the Declaration, the Association was charged with maintaining the common areas and enforcing the Declaration. (*Id.)* All improvements to the common area required prior Board approval. (*Id.* at 498.) After plaintiff's unit was burglarized, plaintiff made repeated requests that the Association increase lighting in the common area. When the Association failed to do so, the plaintiff installed lighting without the requisite prior approval. (*Id.* at 497.) Although the Association was aware of numerous criminal incidents in the area and other complaints about the lack of lighting, the Association compelled plaintiff to remove and forego the use of the unauthorized lighting. In order to comply with the Association's order, she had to turn off the power to all of her exterior lighting. As a result, the unit was in total darkness on the night that she was raped and robbed. (*Id.* at 498.)

The Court held that plaintiff had stated a cause of action for negligence against the Association and its directors. (*Id.* at 498.) In doing so, the Court noted that the Association's obligation to maintain the common areas imposed on the Association and its directors an ordinary duty of care not to injure third parties. (*Id.* at 502, 506.) In reaching this conclusion, the Court determined that the Association "should be held to the same ***standard of care as a landlord***." (*Id.* at 499; emphasis added.) The court acknowledged that a landlord-tenant relationship was not a fiduciary one. (*Id.* at 513.)

In reaching this conclusion, the Court recognized that the Corporations Code imposed a fiduciary duty on the directors to exercise their powers with due care and undivided loyalty owed to the Association. This fiduciary duty extended to the obligation to enforce the governing documents. The Court held, nonetheless, that the Board members complied with their fiduciary duty to enforce the governing documents by compelling the removal of the unauthorized common area lighting installation. (*Id.* at 514.) "**[A] landlord and a tenant do not generally stand in a fiduciary relationship;" and, therefore, the Association and the directors did not have "a fiduciary duty to serve as the Project's landlord**." (*Id.* at 513; emphasis added.) Thus, the Court in *Frances T.* recognized that whether the Association and its directors are held to a fiduciary standard of care may depend on what function they are attempting to discharge.

Not all states recognize this dichotomy in duties based on the functions being discharged. In *Siddons v. Cook* (N.J. Super. Ct. App. Div. 2005) 382 N.J.Super. 1, a homeowner sued her condominium association for water damage caused by a broken dishwasher hose from the upstairs unit. The association was aware that other dishwasher hoses had broken in other units, but failed to disclose this fact the plaintiff. The trial court held that the Association had no duty to warn plaintiff of the potential flooding hazard. The appellate court reversed. (*Id.* at 5.)

The *Siddons* court recognized that "a condominium association has a fiduciary obligation to its unit owners." (*Id.* at 11.) Unlike the California Court in *Francis T*, the New Jersey court in *Siddons* did not limit the scope of the application of this fiduciary duty when the association was discharging analogous landlord obligations. To the contrary, the appellate court imposed a heightened duty to warn of the alleged hazardous flooding condition because of the fiduciary status it occupied vis-à-vis the homeowner. (*Id.* at 10-12.)[3] This ruling is consistent with other New Jersey cases holding that the "fiduciary obligation" of a homeowners association's Board of Directors ". . . includes the duty to preserve and protect the common elements and areas for the

[3] In many states, there is no duty to disclose facts absent a fiduciary or confidential relationship. (See, *e.g.*, *Kovich v. Paseo Del Mar Homeowners' Assn.* (1996) 41 Cal.App.4th 863, 866; *La Jolla Village Homeowners' Assn. v. Superior Court* (1989) 212 Cal.App.3d 1131, 1151; *see also*, unreported Texas case *Smith v. Aramark Corporation*, 2014 WL 12714767, *3.)

benefit of all its members." (*See, e.g., Kim v. Flagship Condominium Owners Ass'n* (2000) 327 N.J. Super. 544, 550.)

2. Use and Safekeeping of Funds—Definitely Fiduciary

As the association's fiduciary duty includes "the duty to preserve and protect the common elements and areas for the benefit of all its members,"[4] it goes without saying that one of the primary duties of an association is the maintenance of common areas and other financial components outlined in the association's governing documents. It logically follows that the use and safekeeping of funds necessary to discharge these obligations is encompassed within the association, director's and officer's fiduciary duties exercised for the benefit of the association membership.[5] For example, in most states, statutes and/or the governing documents impose obligations to create proper replacement funding programs for future capital needs. The powers and duties of the governing body of an association include enforcement of covenants, conditions, and restrictions, as well as the articles, bylaws, and other instruments for the ownership, management, and control of any subdivision that are enacted for the benefit of the commonality.

In addition, association tasks that insure the financial well-being of the membership's property investment are fiduciary in nature. Such duties include: paying taxes and assessments that could become a lien on the common area; contracting for insurance; preparing budgets and financial statements; initiating disciplinary proceedings against members; and entering on any privately owned separate interest as necessary for construction or emergency repair for the benefit of the owners in common.

Statutory or contractual limitations placed on directorial authority often signify the fiduciary nature of the task. For example, many associations prohibit Board action absent membership approval to: contract with third persons for goods or services for a term longer than 1 year (usually excluding contracts for public utilities, insurance, laundry fixtures, cable television, fire alarm equipment, and other similar contracts); incur expenditures for capital improvements in excess of 5% of budgeted gross expenses; sell association property valued at more than 5% of the budgeted expenses; and pay compensation (as opposed to reimbursing expenses) to directors or officers. These limits reflect the fiduciary nature of these acts, and, therefore, impose strictly scrutiny of such actions.

Further, in many states, unless the governing documents of an association impose more stringent standards, the Board of Directors of the association must perform certain fiscal duties, including: reviewing a current reconciliation of the association's operating and reserve accounts; reviewing the current year's actual reserve revenues and expenses compared to the current year's budget; review the latest account statements prepared by the association's financial institutions; and review income and expense statements.[6] These statutes clarify the directors' fiduciary

[4] *Kim v. Flagship Condominium Owners Ass'n, supra*, 327 N.J. Super. at 550.
[5] *See,* Black's Law Dictionary abridged Sixth Edition, definition of "fiduciary duty" as "a duty to act for someone else's benefit, while subordinating one's personal interests to that of the other person."
[6] *See, e.g.,* Cal. Civ. Code § 5500.

obligations by expressly dictating what the minimum standard of care is for a director. The failure to complete these obligations would be on its face a breach of the fiduciary duty.

3. Enforcement of CC&Rs—Depends on Provision Being Enforced?

The California Supreme Court in *Nahrstedt v. Lakeside Village Condominium Association* (1994) 8 Cal.4th 361, 383, stated that "the owners associations [are] charged with the fiduciary obligation to enforce those restrictions."

> Of course, when an association determines that a unit owner has violated a use restriction, the association must do so in good faith, not in an arbitrary or capricious manner, and its enforcement procedures must be fair and applied uniformly. (See *Ironwood Owners Assn. IX v. Solomon* (1986) 178 Cal.App.3d 766; *Cohen v. Kite Hill Community Assn.* (1983) 142 Cal.App.3d 642.)

(*Id.*) Accordingly, "[u]nder well-accepted principles of condominium law, a homeowner can sue the association for damages and an injunction to compel the association to enforce the provisions of the declaration." (*Lamden v. La Jolla Shores Clubdominium Homeowners Association* (1999) 21 Cal.4th 249, 268).

At least one Florida case where the court found that the fiduciary standard to be applied will vary depending on the role the association is undertaking. As a result, it can be argued, that depending upon the association's function being exercised by directors will alter their obligation from a fiduciary to a lesser standard, such as simple negligence. This notion of a lesser standard of care is found in *Porto v. Carlyle Plaza, Inc.* (2007) 971 So.2d 940, where a non-resident was walking their dog on a leash on the public sidewalk. While walking the dog, the dog owner left the sidewalk and went on to a grassy area on the side of association's driveway for the dog to "relieve itself." The dog owner walked on the grass, across the driveway, and was walking back to the sidewalk when she tripped and fell over a piece of metal, adjacent to the public sidewalk and protruding from association's driveway. The piece of metal was part of a gate that had been removed from that location when another one was installed closer to the building years prior to this incident. The dog owner sustained injuries and sued the association for negligence. The trial court granted final summary judgment in favor of the association finding that the association did not breach any duty of care owed to *Porto*.

Acknowledging that the association had an obligation under the governing documents to maintain the common area, the appellate court in *Porto* found that a landowner's duty of care depends on the status of the property entrant. (See, *Lukancich v. City of Tampa*, (1991) 583 So.2d 1070. The appellate court went on to find that, as a matter of law, the dog owner was an uninvited licensee upon the association's property. It was undisputed that the dog owner's presence on the association's property was solely for her own convenience without an invitation expressed or implied by the association. The dog owner, therefore, met the definition of an uninvited licensee under Florida case law. (See, *Wood v. Camp* (1973) 284 So.2d 691, which defines an uninvited licensee as one who chooses to come upon the premises solely for their own convenience without either an expressed or implied invitation.) The duty of care an association owes, as a landowner, to an uninvited licensee is to refrain from willful misconduct or wanton negligence, to warn of known dangers not open to ordinary observation, and to refrain from intentionally exposing the uninvited licensee to danger. (See *Lane v. Estate of Morton* (1997) 687 So.2d 53; see also *Barrio v. City of Miami Beach*, (1997) 698 So.2d 1241, which held that where material facts are not in dispute it is appropriate to determine legal status of visitor on property as a matter of law. See also generally Restatement (Second) of Torts § 368, comment g.)

In *Porto*, the court concluded that the association did not breach any duty of care owed to the dog owner. The association's conduct was neither willful or wantonly negligent, nor intentional in light of the unreasonable probability of the pedestrian's conduct. (See, *Schroeder v. Grables Bakery Inc.* (1963) 149 So.2d 564, which affirmed defendant's summary judgment where licensee left sidewalk and tripped over a scale two inches off of sidewalk on defendant's property.)

The *Porto* case may be distinguished from the above-cited California authorities by virtue of the fact that the plaintiff was not a member of the association. Therefore, the association did not owe the plaintiff a fiduciary duty to maintain the common areas. However, in *Frances T.*, *supra*, at 519, the association certainly had a duty to maintain the common area pursuant to its governing documents. Nonetheless, as discussed above, the Court did not equate the failure to discharge its maintenance responsibilities as a breach of fiduciary duty. Thus, whether the failure to enforce governing documents is interpreted as a breach of fiduciary duty may depend upon the role being performed or provision being enforced.

IV. <u>WHAT ARE THE OBLIGATIONS OF A FIDUCIARY?</u>

In the United States, a homeowner or condominium association is a private association normally formed by a real estate developer for the purpose of marketing, managing, and selling homes and lots in a residential subdivision or condominium project. State corporation laws are what mostly dictate the fiduciary responsibilities of an association's Board of Directors, although many states also have common interest community statutes which include additional requirements and duties of volunteer association Board members. State law typically requires that Board members keep the best interest of their association (which is normally a nonprofit corporation) in mind when making and carrying out decisions on behalf of the association.

Those in positions of responsibility and authority in the governance structure of an association (both community association volunteer leaders who serve without compensation and employed staff) may have fiduciary duties to the association, including duties of care, loyalty, and obedience. In short, the existence of a fiduciary relationship means the fiduciary is required to act reasonably, prudently, and in the best interest of the association.[7] Fiduciaries also must

[7] *McRedmond v. Estate of Marianelli* (Tenn: Court of Appeals, Middle Section 2000) 46 SW 3d 730. In determining whether a fiduciary duty exists in this case, the Court of Appeals held that a fiduciary is a person or entity holding the character of a trustee. A fiduciary duty is the duty to act primarily for another's benefit. With respect to directors in a close corporation "They are required to act in the utmost good faith, and . . . they impliedly

not engage in activities which could be viewed as negligent or fraudulent, and they must avoid conflicts of interest. If the fiduciary duties of care, loyalty, or obedience are breached, the individual(s) breaching the duty could potentially be personally liable to the Association for any damages caused to the Association as a result of the breach. Generally speaking, this fiduciary duty is a duty owed to the Association as a whole and extends even to those who only serve on a particular committee.

As mentioned above, MBCA Section 8.30 includes "Standards of Conduct for Directors." These Standards of Conduct are comprised of duties encompassing three areas: (1) the duty of loyalty; (2) acting within the scope of the association's authority; and (3) the duty of care.

A. Duty of Loyalty

The duty of loyalty is often referred to as the duty of good faith. It prevents association Board members from acting on any association-related decision for personal gain or interest. Instead, members must act in good faith, fairly, and in the best interest of the entire association. This principle does not mean that the association always must protect the interest of an individual member. To the contrary, the corporate interest is not always aligned with an individual owner's interest. "[A]nyone who buys a unit in a common interest development with knowledge of its owners association's discretionary power accepts 'the risk that the power may be used in a way that benefits the commonality but harms the individual.'" (*Nahrstedt v. Lakeside Village Condominium Assn.*, supra, 8 Cal.4th at 374 [citation omitted].)

1. Conflict of Interest Transactions

The duty of loyalty encompasses a duty to avoid or at the very least disclose conflicts of interest. A contract or business arrangement between the association and a director or officer of the association that has a direct or indirect interest is a conflict of interest transaction. A director or officer has such an interest if another entity in which the director or officer has a material interest is a party to the transaction or another entity of which the director or officer is a director, officer or trustee is a party to the transaction.

On a more mundane level, a director may violate the duty of loyalty even when he/she does not receive a financial benefit. For example, giving friends or family members' advantages or voting on an issue upon which the Board member may be biased may render the transaction voidable if the director fails to disclose his interest or bias in the transaction.

2. Duty to Maintain Confidences

Board members are privy to association members' confidential personal and financial information. In addition, Board members receive privileged attorney communications delivered for the benefit of the corporation. The duty of loyalty also imposes a duty to maintain the confidences of the corporation.

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undertake to give to the enterprise the benefit of their care and best judgment and to exercise the powers conferred solely in the interest of the corporation . . . and not for their own personal interests."

While there may be competing political and financial interests within the membership population, any information in the possession of one or all of the members of the Board, which is confidential in nature, must remain strictly confidential. A director cannot disclose corporate confidences, without the consent of the Board, regardless of whether the director agrees with the Board's decision to maintain the confidentiality of the information. "Corporate officers and directors are not permitted to use their positions of trust and confidence to further their private interests." (*Guth v. Loft* (1939) 23 Del.Supr. 255, 5 A.2d 503, 510.)

A caveat to this rule is the above-referenced duty to act in good faith to facilitate the best interests of the corporation. This duty mandates that a fiduciary refrain from approving or engaging in wrongful or illegal activity. This latter facet may create a duty for a fiduciary to act to correct or prevent illegal conduct. For example, fiduciaries should seek the termination of Association employees whose actions put the Association at unjustified risk. This duty prevents the Association from being exposed to liability through agency legal doctrines, such as respondeat superior. (*Jones v. Lodge at Torrey Pines* (2008) 42 Cal.4th 1158, 1173.) In such cases, the fiduciary arguably may share with third parties otherwise confidential information in order to prevent illegal conduct by another fiduciary that may expose the association to liability.

B. Acts within the Scope of Authority

The duty to act within an association's scope of authority means a Board of Directors should not act on matters or make decisions without the authority to back up the action. Said authority is drawn from state laws and governing documents of the association.[8] Board members, officers, committee members and even the association's professional managers should be careful not to take any action or make any representation on behalf of the association which has not first been approved by the Board. Depending on the circumstances, negotiating and signing contracts for services without prior Board approval or subsequent ratification could subject the Association and/or Board members to liability claims.[9]

1. Authority and Actions by the Board of Directors

Unless the Corporate Charter, the Declaration, Master Deed, By-Laws or State law provides otherwise, the Board acts by consensus (a majority vote in most cases),[10] typically at a duly constituted and conducted meeting, or by unanimous written consent. In most states, Boards cannot conduct business by mail, fax, or electronic ballot. The Board may delegate authority to act on its behalf to others, such as committees, but in such cases the committees serve at the pleasure of, and are supervised by, the Board.[11] The association, therefore, remains legally responsible for any actions taken by the committees or persons to whom the Board delegates authority. An individual Board member has no individual management authority simply by virtue of being a member of the Board. The Board, however, may delegate additional authority to a Board member such as when it appoints Board members to committees. Similarly, an officer

[8] "The duties and powers of a homeowners association are controlled both by statute and by the association's governing documents." (*Ostayan v. Nordhoff Townhomes Assn., Inc*, *supra*, 110 Cal.App.4th at 127.)
[9] *See*, *e.g.*, *Palm Springs Villas II Homeowners Association, Inc. v. Parth* (2016) 248 Cal.App.4th 268, 285.
[10] Robert's Rules of Order Newly Revised 11th Edition, Chapter XVI.
[11] *See*, *e.g.*, Cal. Corp. Code § 9212.

only has the management authority explicitly delegated to that position in the By-Laws or by the Board, although the delegated authority can be general and broad.

2. Authority and Actions by Committees

Committees have no management authority except for any authority delegated to them by the By-Laws or by the Board. Furthermore, under most state nonprofit corporation laws, certain functions may not be delegated by the Board to committees. For example, in many states, the Board may not delegate to committees the power to elect officers, fill vacancies on the board or any of its committees, amend the By-Laws, or approve a plan of merger or dissolution.[12]

3. Authority and Actions by Employees.

Employees have no management authority except such authority as specifically delegated to them in the By-Laws or by the Board. For example, for those associations who have staff, many associations' By-Laws delegate to the head staff executive the responsibility for the day-to-day operations of the Association's administrative offices, including the responsibility to hire, train, supervise, coordinate, and terminate the professional staff of the association, as well as the responsibility for all staffing and salary administration within guidelines established by the Board.

Association members have no management authority, as such authority is held by the Board of Directors. However, state nonprofit corporation laws and Association By-Laws generally reserve to members the right, inter alia, to remove officers and directors and to amend the association's articles of incorporation. Under some associations' By-Laws, certain matters, such as the amendment of the By-Laws or the election of officers and directors, must be submitted to the membership for a vote. However, most other matters generally are not submitted to the full membership, but rather are handled by the Board, one or more of its committees, or the officers or employees of the association.

4. Apparent (Ostensible) Authority

In *American Society of Mechanical Engineers, Inc. v. Hydrolevel Corp., 456 US 556 (1982)*, the U.S. Supreme Court determined that an association can be held liable for the actions of its officers, directors and other volunteers (including actions that bind the Association financially), even when the association does not know about, approve of or benefit from those actions, as long as the volunteer reasonably appears to outsiders to be acting with the association's approval (i.e., with its "apparent authority"). The Supreme Court made clear that associations are to be held strictly liable for the activities of volunteers that have even the apparent authority of the association. Even if an association volunteer does not, in fact, have authority to act in a particular manner on behalf of the Association, the law will nevertheless hold the association liable if third parties reasonably believe that the volunteer had such authority.

The law, thus, requires an association to take reasonable steps to ensure that the scope of its agents' authority is clear to third parties. Agents (e.g., officers, directors, committee members

[12] *See, e.g.*, Cal. Corp. Code § 9212.

and even employees) should not be able to hold themselves out to third parties as having authority beyond that which has been vested in them by the association. Regardless of whether a particular member of the Board, an officer, committee member or community manager has the actual authority to sign the contract, if the service provider reasonably believes that person has such authority, then under the doctrine of apparent authority, the association would be bound by the terms of that contract.[13] For example, an association manager, who enters into contracts for association services, will bind the association to the terms of those contracts if the service providers reasonably believe the association manager has the authority to sign contracts on behalf of the association.

C. Duty of Care

The care component of fiduciary duty is often characterized as a duty of reasonable inquiry and informed consent.[14] In attempting to discharge this duty of care, board members may rely on information, opinions, reports or statements, including financial statements and other financial data **IF** prepared or presented by:

1. officers or employees of the association;
2. legal counsel or accountants;
3. committees of the association; or,
4. volunteers and other people which the director believes to be within such person's professional or expert competence.

(MBCA, § 8.30(c).) When relying on information or data prepared or presented by other people, Board members must reasonably believe that such people are reliable and competent in the matters in which they provide such information, opinions, reports or statements, including financial statements and other financial data.

Although it may not be required expressly under the law, a working knowledge and familiarity of its governing documents including the By-Laws, Corporate Charter, Master Deed or Declaration is helpful, if not necessary, to carrying out the association's duties and obligations. For example, before assessing fines for the violation of a covenant or rule, the Board must comply with directives for assessing such fines outlined in the Association's covenants conditions and restrictions, By-Laws, rules and regulations, and written fine policies. These procedures should be uniformly and consistently enforced.[15] A director may not assess fines to a

[13] In *American Society of Mechanical Engineers, Inc. v. Hydrolevel Corp., supra, 456 US at 556*, the U.S. Supreme Court held that Hydrolevel was liable according to the doctrine of apparent authority even though the Plaintiff's leadership was unaware of the action the volunteer chairman took, it had not approved the action, and did not benefit from the action. The Court reasoned that under an apparent authority theory, "liability is based upon the fact that the agent's position facilitates the consummation of the fraud, in that from the point of view of the third person the transaction seems regular on its face and the agent appears to be acting in the ordinary course of the business confided to him."

[14] *See, e.g.*, MBCA § 8.30(a); Cal. Corp. Code § 7231(a).

[15] "When a homeowners' association seeks to enforce the provisions of its CCRs to compel an act by one of its member owners, it is incumbent upon it to show that it has followed its own standards and procedures prior to pursuing such a remedy, that those procedures were fair and reasonable and that its substantive decision was made in good faith, and is reasonable, not arbitrary or capricious." (*Ironwood Owners Association IX v. Solomon* (1986) 178 Cal.App.3d 766, 772.)

homeowner for doing something to their home that the director simply does not like. Directors may not take actions or impose fines against association members that are arbitrary or capricious.

Board members and officers, or at the very least their retained professionals and experts, should be familiar with applicable state and federal laws (e.g,, the Federal Fair Housing Act (FFHA),[16] Housing and Urban Development (HUD)[17] policy positions, and their state law equivalents). Without a basic understanding of these laws and regulations, or ready access to professionals and experts with such knowledge, a board member or officer may not have the ability to identify issues such as quid pro quo hostile environment harassment, discrimination based upon a protected class or when it must grant a unit owner's request for an emotional support or service animal. In most situations, directors and officers can and should rely on attorneys and managing agents to help inform them regarding, and guide them through, the Association's legal obligations.

V. <u>TO WHOM ARE FIDUCIARY DUTIES OWED?</u>

A combination of common law, statute and case law typically establishes the types of fiduciary duties which exist in all states. In Tennessee for example, there are two principal categories of fiduciary duties. The first category consists of relationships that are fiduciary *per se*, sometimes referred to as legal fiduciaries, such as the relationship between a guardian and ward, an attorney and client and principal and agent.[18] The second category consists of relationships that are not *per se* fiduciary in nature, but arise in situations where one party exercised 'dominion and control over another. This relationship, often referred to as a confidential relationship, is not merely a relationship of mutual trust and confidence, but rather it is one where confidence is placed by one in the other and the recipient of that confidence is the dominant personality, with ability, because of that confidence, to influence and exercise dominion and control over the weaker or dominated party.[19] Relationships which are not fiduciary in nature are not confidential per se and require proof of the elements of dominion and control in order to establish the existence of a confidential relationship.

Because of the nature of the relationship between the Board of Directors to the association and the members who elected them to serve in such capacity, the duties of the Board of Directors are not *per se* fiduciary in nature. Therefore, the Board owes a fiduciary duty to the association entity and, in some cases, its individual members.

Obviously, the association and the directors do not always have a fiduciary duty to protect an individual. Sometimes enforcement of the governing documents does not inure to the benefit of the owner, but does benefit the association as a whole. In which case, the fiduciary duty is owed to the association, but not the individual owner. (*See*, *Nahrstedt v. Lakeside Village Condominium Assn.*, supra, 8 Cal.4th at 374.)

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[16] Federal Fair Housing Act. 42 U.S.C. § 3601-3619.

[17] 24 CFR 100.202-General prohibitions against discrimination because of handicap. 24 CFR 100.6(H)-Discriminatory Conduct under the Federal Fair Housing Act. Quid Pro Quo and Hostile Environment Harassment. 24 CFR 100.204-Reasonable Accommodations.

[18] *Iacometti v. Frassinelli* (Tenn.Ct.App. 1973) 494 S.W.2d 496, 499.

[19] *Matlock v. Simpson* (Tenn. 1995) 902 S.W. 2d 384.

VI. BREACH OF FIDUCIARY DUTY

A. Malfeasance and Nonfeasance

The Board of Directors is the governing body of the Association, responsible for the ultimate direction and management of the affairs of the Association. The Board sets the policy and directs its professional community manger and in many cases the association's officers, to carry out the policies. Although individual board members may not actually carry out and execute the policies it creates, the action and inaction of the Board and its members legally bind the association.

Directors cannot remain willfully ignorant of the affairs of the Association.[20] A director appointed as treasurer for example, with limited knowledge of finance, should not simply rely upon the representations and reports of staff or auditors that "all is well" with the association's finances. Moreover, officers and directors acting outside the scope of or abusing their authority as officers and directors, may be subject to personal liability arising from such actions. Furthermore, officers or directors who, in the course of the association's work, intentionally cause injury or damage to persons or property, may find themselves personally liable even though the activity was carried out on behalf of the association.

B. Business Judgment Rule

A breach of fiduciary duty will not necessarily impose liability. A director may be insulated from liability by the business judgment rule. The business judgment rule has been employed in the United States as a principle of corporate governance for approximately 160 years.[21]

> 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."[22]

(*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.)

The business judgment rule evolved concurrently with the duty of care. In fact, the cases in which courts originally articulated the duty of care also discussed the business judgment of directors and officers. Many of these early cases simply stated that directors and officers were

[20] *See, Gaillard v. Natomas Co.* (1989) 208 Cal.App.3d 1250, 1263.
[21] S. Arsht , *The Business Judgment Rule Revisited*, Hofstra Law Review (1979) Vol. 8: Iss. 1, Article 6, p. 93.
[22] "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.)

not liable for honest mistakes or errors of judgment.[23] Other cases held that directors and officers incurred liability only for errors "of the grossest kind."[24] The rule basically states that if any rational business purpose exists for directors' or officers' decisions, they are not liable for good faith errors in judgment when their decisions result in an unfavorable outcome for the corporation. "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." (S. Arsht, *The Business Judgment Rule Revisited* (1979) Hofstra Law Review: Vol. 8: Iss. 1, Article 6, p. 98.)

As with almost all states, Tennessee has codified its own version of the Business Judgment Rule. As recited in Tennessee Code Annotated § 48-58-601(b), the Tennessee General Assembly has taken the position that:

> . . . the services of nonprofit boards are critical to the efficient conduct and management of the public and charitable affairs of the citizens of this state. Members of such nonprofit boards must be permitted to operate without concern for the possibility of litigation arising from the discharge of their duties as policy makers.

As such, in Tennessee, all directors and officers shall be immune from suit arising from the conduct of the affairs of the association unless their conduct amounts to willful, wanton or gross negligence.[25]

Other states that have adopted some form of MBCA section 8.30 conditioning business judgment rule protection upon demonstration of reasonable diligence under the circumstances.[26] For example, the California Corporations Code Section 7231(a) 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.

[23] "[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.)

[24] "[U]nder the business judgment rule[,] director liability is predicated upon concepts of gross negligence." (*Katz v. Chevron Corp.* (1994) 22 Cal.App.4th 1352, 1366-1367, quoting *Aronson v. Lewis* (Del. Super. Ct. 1984) 473 A.2d 805, 812; see also, *Smith v. Van Gorkom* (Del. Super. Ct. 1985) 488 A.2d 858, 873.)

[25] "All directors...of the governing bodies of…associations…shall be immune from suit arising from the conduct of the affairs of such association. Such immunity from suit shall be removed when such conduct amounts to willful, wanton or gross negligence." T.C.A. § 48-58-601(c).

[26] According to Marsh et al., Marsh's Cal. Corp. L. (2016) DUTY OF CARE, § 11.03(A), p. 11-15 , cases in the United States holding directors liable for "mere negligence" are "virtually nonexistent."

(Emphasis added.)[27] In such states, this inquiry involves both the objective reasonable person standard under like circumstances, and a subjective analysis of whether the fiduciary in fact acted in good faith.

The subjective good faith component, i.e., acting in the best interest of the association, involves an exploration of the substance behind a fiduciary's decision. It does not require fiduciaries to make perfect decisions, but merely requires that they act or make decisions that the fiduciary actually believes to be in the best interests of the corporation. The decision must be related to furthering an association interest.

The objective component, i.e., reasonable inquiry, requires that the director act with such care "as an ordinarily prudent person in a like position would use under similar circumstances." An evaluation of "due care, including reasonable inquiry" must take into account the circumstances of the claims, background and qualifications of the director, and the nature of the corporation.

> The term 'under similar circumstances' requires a court to consider the nature and extent of a director's alleged oversight or mistake in judgment in the context of such factors as the size, complexity and location of activities involved, and to limit the critical assessment of a director's performance to the time of the action or non-action and thereby avoid the harsher judgments which can be made with the benefit of hindsight.

(*Gaillard v. Natomas Co., supra*, 208 Cal.App.3d at 1265.) As referenced above, a director is entitled to rely on information provided by: (1) one or more officers or employees of the homeowners association whom the director believes to be reliable and competent as to the matters presented; or (2) counsel, independent accountants, or management agents as to matters which the director believes to be within such person's professional or expert competence. (MBCA, § 8.30(c).) Thus, if a director in good faith relies on erroneous advice from an expert, the director's reasonable reliance may be protected.

C. Remedies for Violation of Fiduciary Duties

What happens when corporate officers and directors do not, contrary to their fiduciary duties, protect association assets, ensure resources are used to achieve the association purposes, or otherwise prohibit self-dealing? Most states have remedies which may be imposed under such circumstances. In Tennessee, for example, Tenn. Code Ann. § 48-64-301 authorizes dissolution of a nonprofit corporation in a proceeding brought by a specified number or percentage of voting members upon proof of one of several grounds, including where "the corporate assets are being misapplied or wasted" or where "the directors or those in control of the Association have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent."[28]

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[27] *See also, Cal.* Corp. Code §§ 309(a), and 7231.5(a).

[28] As discussed *infra*, typically lawsuits may be brought against the Association, directors, and officers for breach of fiduciaries subject to the above discussed rules. (*See, e.g., Lamden v. La Jolla Shores Clubdominium Homeowners Association, supra*, 21 Cal.4th at 268; *Siddons v. Cook, supra*, 382 N.J.Super.at 11.

Directors whose actions are found to violate any of the duties owed to the Association, and whose conduct is not protected by the business judgment rule, can be held personally liable for their actions.[29]

VII. <u>WHY DOES IT MATTER WHETHER THE ASSOCIATION, A DIRECTOR, AN OFFICER, OR MANAGER IS ACTING AS A FIDUCIARY?</u>

We know what you are thinking. The above discussion as to the nature, obligations, and history of fiduciaries is certainly engrossing. However, why does it matter if a director, officer, or manager is acting as a fiduciary? We are glad you asked. If you were not here, we would have to invent you. A director, manager, or committee member must be cognizant of their role in the association and the obligation they are meeting under the governing documents or the law as these factors may determine whether and when a fiduciary duty is imposed.

A. Whether One Is a Fiduciary Determines what Standard of Care Is Applied.

A fiduciary standard of care is a heightened standard of care as compared to an ordinary duty of care.

> Ordinary or reasonable care is that care which persons of ordinary prudence would use in order to avoid injury to themselves or others under circumstances similar to those shown by the evidence. [You will note that the person whose conduct we set up as a standard is not the extraordinarily cautious individual, nor the exceptionally skillful one, but a person of reasonable and ordinary prudence.]

(California Civil Jury Instructions (BAJI), September 2018 Update, 3.10.) Not only does the fiduciary have to exercise at least ordinary care, but he/she must place the interest of the other party above his or her own.

As referenced above, a fiduciary relationship imposes "a duty to act with the utmost good faith in the best interests of "the other party." (Judicial Council Of California Civil Jury Instruction (CACI) 4100; *Wolf v. Superior Court* (2003) 107 Cal.App.4th 25, 29.) "[C]onfidence is reposed by one person in the integrity of another, and in such a relation the party in whom the confidence is reposed, if he voluntarily accepts or assumes to accept the confidence, can take no advantage from his acts relating to the interest of the other party without the latter's knowledge or consent. …'" (*Wolf v. Superior Court*, *supra*, 107 Cal.App.4th at 29, internal citations omitted.)

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[29] *See, e.g., Raven's Cove Townhomes, Inc. v. Knuppe Development Co.*, *supra*, 114 Cal.App.3d at 792-799; *Frances T. v. Village Green Owners Assn.*, *supra*, 42 Cal.3d at 498.

Even states such as Delaware that have not adopted the MBCA's Standards of Conduct for Directors impose an unyielding fiduciary duty to protect the interests of the corporation and to act in the best interests of its shareholders/members. (*Guth v. Loft, Inc.* (Del.Supr. 1939) 5 A.2d 503, 510; *Aronson v. Lewis,* (Del.Super. Ct. 1984) 473 A.2d 805, 811; Smith v. Van Gorkom (Del. Super. Ct. 1985) 488 A.2d 858, 872; *Mills Acquisition Co. v. Macmillan, Inc.* (Del.Supr.1988) 559 A.2d 1261, 1280.)

B. A Fiduciary's Failure to Disclose a Material Fact May Give Rise to a Constructive Fraud Claim.

Whether the association, the director or officer, or the managing agent is acting as a fiduciary determines if they have a duty of disclosure in a given set of circumstances, and, if so, the scope of such an obligation. The failure to properly evaluate and identify the scope of a disclosure obligation can give rise to a fraud claim if it can be established that the association, or its director, officer, or management agreement obtained a benefit out of the transaction.

In many states, the general rule is that there is no duty to disclose facts absent a fiduciary or confidential relationship. (See, e.g., *Kovich v. Paseo Del Mar Homeowners' Assn.* (1996) 41 Cal.App.4th 863, 866; *La Jolla Village Homeowners' Assn. v. Superior Court* (1989) 212 Cal.App.3d 1131, 1151; see also, unreported Texas case *Smith v. Aramark Corporation*, 2014 WL 12714767, *3.) However, a fiduciary may be liable for constructive fraud based on a non-disclosure. (See, *e.g.*, Cal. Civ. Code § 1573.)

In a constructive fraud claim, the plaintiff must show: "(1) a fiduciary relationship, (2) nondisclosure, (3) intent to deceive, and (4) reliance and resulting injury." (*Tindell v. Murphy* (2018) 22 Cal.App.5th 1239, 1249–1250.) Because of the fiduciary relationship, a rebuttable presumption that the plaintiff reasonably relied on the nondisclosure ordinarily will attach if the fiduciary obtained an advantage as a result of the nondisclosure.

> In general, fraud will not be presumed, [citation omitted] but a presumption of fraud and undue influence may arise in the case of a confidential relationship from which an undue advantage was gained.

(*Solon v. Lichtenstein* (1952) 39 Cal.2d 75, 82; *see also, d'Elia v. Rice Development, Inc.* (Utah Ct. App. 2006) 147 P.3d 515, 528.) "Further, the reliance element is relaxed in constructive fraud to the extent we may presume reasonable reliance upon the misrepresentation or nondisclosure of the fiduciary, absent direct evidence of a lack of reliance." (*Estate of Gump* (1991) 1 Cal.App.4th 582, 601.)

The defendant fiduciary bears the burden of rebutting the presumption **by proving by substantial evidence that the plaintiff could not have reasonably relied on the misleading information or omission**. (*Edmunds v. Valley Circle Estates* (1993) 16 Cal.App.4th 1290, 1301–1302; *Sullivan v. Mebane Packaging Group, Inc.* (N.C. Ct. App. 2003) 158 N.C.App. 19, 32–33.)

When a fiduciary relationship exists between the parties to a transaction, a presumption of fraud arises when the superior party obtains a possible benefit, but this presumption disappears if that party can show, for instance, that the other party acted on independent advice."

(*Watts v. Cumberland County Hosp. Systems, Inc.* (1986) 317 N.C. 321, 324.)

In some states, the burden to overcome the presumption of reliance requires more than just a preponderance of evidence. Virginia is one such state. "[W]hen a presumption of constructive fraud arises, the burden of proof shifts to the fiduciary to produce **clear and convincing evidence** to rebut the presumption." (*Grubb v. Grubb* (2006) 272 Va. 45, 53; emphasis added.)

C. When a Director Receives a Benefit from a Transaction with the Association, the Law Imposes a Burden on the Fiduciary to Demonstrate the Fairness of the Transaction.

As discussed above, because of the fiduciary's duty of loyalty, conflict of interest transactions between the Association and a director or officer are subject to close scrutiny. When the fiduciary receives a benefit from a transaction, the duty of loyalty imposes a burden of proof upon the officer or director to demonstrate the transaction was fair at the time it was entered into and approved in accordance with statutory requirements. The transaction may be voidable by the Association unless the fiduciary demonstrates the following facts:

> (1) The material facts of the transaction and the director's or officer's interest were disclosed or known to the Board of Directors or a committee consisting entirely of members of the Board of Directors and the Board of Directors or such committee authorized, approved, or ratified the transaction;
>
> (2) The material facts of the transaction and the director's or officer's interest were disclosed or known to the members and they authorized, approved, or ratified the transaction; or
>
> (3) Approval is obtained from a court of record having equity jurisdiction in an action in which the attorney general is joined as a party.[30]

VIII. CAN A FIDUCIARY CONTRACT OUT OF FIDUCIARY DUTIES?

The vast majority of states allow corporations to contract around the duty of care by limiting or eliminating the personal liability of a corporate director for breaching the duty of care. (G. Rauterberg & E. Talley, *Contracting Out Of The Fiduciary Duty Of Loyalty: An*

[30] *See, e.g.*, *Tenn.Code Ann.* § 48–58–302(a); *Cal. Corp. Code* § 7233(a); *N.C. Gen.Stat.* § 55-8-31; *Willard ex rel. Moneta Bldg. Supply, Inc. v. Moneta Bldg. Supply, Inc.* (1999) 258 Va. 140, 153–154; *In re Sunrise Island, Ltd.* (Bankr. N.D. Okla. 1996) 203 B.R. 171, 175.

Empirical Analysis Of Corporate Opportunity Waivers, Columbia Law Review, (2016) Vol. 117, No. 5, 7/58, and 8/58; see, e.g., Del. Code Ann. tit. 8, § 102(b)(7) [empowering corporations to eliminate "the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director]." However, traditionally the duty of loyalty, i.e., duty of good faith, could not be contractually exculpated. "In stark contrast to the duty of care, loyalty has traditionally been immutable." (G. Rauterberg, *supra*, at 8/58.)

Accordingly, while in corporate settings most states authorize corporations to limit the liability of directors, the duty of loyalty generally prohibits contracting out of one's own liability for willful misconduct. As pointed out by the Supreme Judicial Court of Massachusetts, "exculpatory provisions will not be enforced where the fiduciary commits a breach of trust in bad faith *or* intentionally *or* with reckless indifference to the interest of the beneficiary *or* as to breaches from which the trustee has realized a profit." (*Demoulas v. Demoulas Super Markets, Inc.* (1997) 424 Mass. 501, 515; *see also, Sullivan v. Mosner* (1972) 266 Md. 479, 496.)

Based on such principles, a court in California, *Cohen v. Kite Hill Community Assn. supra*, 142 Cal.App.3d at 654, invalidated an exculpatory clause in a homeowners association's CC&Rs that immunized a homeowners association from liability for failing to comply with its fiduciary duties, i.e., enforcing its architectural restrictions. In ruling that the exculpatory clause is against public policy, the court observed that "[t]he law has traditionally viewed with disfavor attempts to secure insulation from one's own negligence or wilful misconduct." (*Id.*)

> Furthermore, it is the express statutory policy of this state that "[a]ll contracts which have for their object, directly or indirectly, to exempt anyone from the responsibility for his own fraud or willful injury to the person or property of another, or violation of law, whether willful or negligent, are against the policy of the law." (Civ. Code, § 1668.)

(*Id.*) The court found that **"[t]his public policy applies with added force when the exculpatory provision purports to immunize persons charged with a fiduciary duty from the consequences of betraying their trusts**." (*Id.*; emphasis added.) Moreover, "the California Supreme Court has evinced a clear policy of enforcing only those exculpatory provisions which do not affect 'the public interest.'" (*Id.* at 655.)

Notwithstanding such concerns, courts in California and elsewhere have upheld exculpatory clauses in recorded declarations limiting the liability of homeowners associations and their officers. In *Kelley v. Astor Investors, Inc.* (Ill. App. Ct. 1984) 123 Ill.App.3d 593, 598, an Illinois appellate court reviewed whether interim homeowner association board members were individually liable for structural defects found in common elements. The recorded Covenants, Conditions and Restrictions ("CC&Rs") contained an exculpatory clause which limited the board members' liability to "acts or omissions found to constitute willful misconduct." The court held that the exculpatory clause was valid and protected the board from liability.

> As a general proposition, trust or contractual instruments containing an exculpatory clause for simple negligence are valid unless they violate public policy, involve one of a limited number of semipublic relationships (*e.g.*, common carriers) **or result from overreaching or abuse of a fiduciary relationship**.

(*Id.*; emphasis added.) Since the clause did not immunize the board from abusing the fiduciary relationship and since there was no evidence of overreaching or abuse, the court held that the clause was valid and the board was not liable. (*Id.)*

The Foundation for Community Association Research's The Community Association's Fact Book 2016 suggests that there are between 345,000 and 347,000 community associations in the United States. These non-profit associations are governed by a volunteer lay Board of Directors. In 2016, there were approximately 2,360,000 community association Board and committee members. Given the substantial need for volunteer Board members, it is not surprising that judiciaries have recognized the importance of restricting Board member liability so as to encourage participation on such Boards notwithstanding the concerns raised in *Cohen v. Kite Hill Community Assn.*, *supra*, at 654.

In *Franklin v. Marie Antoinette Condominium Owners Assn.* (1993) 19 Cal.App.4th 824, 829-832, a California Court of Appeal upheld an exculpatory clause in a recorded Declaration of Restrictions. In doing so, the court distinguished the exculpatory clause in *Cohen v. Kite Hill Community Assn.*, *supra*, at 654, as exculpating the homeowners association from ***complying*** with its fiduciary duties. While the court noted that public policy could be construed as prohibiting such exculpation, homeowners in a common interest development could choose to contractually apportion risk between the association and its members for good faith mistakes in judgment. (*Id.* at 829-832.)

The court in *Franklin*, supra, 19 Cal.App.4th at 829-832, explained that immunity provisions condominium development CC&Rs should be enforced given the need to encourage volunteers to serve on the ever-growing number of common interest developments in the state. If such immunity provisions were not enforced, the tens of thousands of residents required to run these homeowners associations would be discouraged from serving. (*Id.* at 830-831, fn. 10.)

> 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.**

(Quoting, *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.)

Given the need for volunteer directors, and the policies against contracting out of fiduciary duties of loyalty, homeowners associations in most states should be able to adopt and enforce exculpatory provisions that limit monetary liability for breaches of duty made in a good faith effort to facilitate the best interest of the corporation. To ensure its enforceability, the clause should not attempt to exculpate the homeowners association from its fiduciary duty to enforce its governing documents.

IX. CONCLUSION

Most Board members and officers do not fully understand when they are acting as fiduciaries or the import of doing so. Others do not see any distinction between the duties owed to the association versus those owed to the members. Certainly, association members often do not appreciate that the Board member's fiduciary duty owed to the corporation does not necessarily impose an obligation to protect the individual members' specific pecuniary or other personal interests. Helping Board members, officers, management, and members navigate this seemingly simplistic, but in actuality complex, area of law inures to everyone's benefit.