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Fiduciary Responsibility of Association Directors: Practical Application of Legal Theory

By Jeffrey A. Barnett, Esq.

Introduction

The law of fiduciary responsibility can be viewed as having two purposes. The first is moral or educational in nature. The law sets a standard for appropriate conduct of association directors. It is intended to guide proper conduct and avoid inappropriate actions. The other role of the law of fiduciary duty is to act as a practical tool for restitution. If a homeowners association is damaged because of a breach of fiduciary duty by the director, the law affords a remedy to recover the resulting damages. A wealth of resources are available to directors to assist in understanding and meeting their fiduciary responsibilities. Books, pamphlets, magazines and newsletters are one source of information. Professional advisors, including attorneys, accountants, reserve study consultants, engineers, architects, insurance brokers and community association management consultants are among the paid advisors who may be engaged to advise on either a narrow issue or more broadly to help directors understand and comply with their legal standard of care.

The ability of volunteer directors to effectively perform their fiduciary duties will ultimately determine the success of common interest developments as a form of housing. While there are widespread examples of successfully run subdivisions, there are unfortunately also well known instances of leadership failures where homeowners associations are in political turmoil, financial collapse and physical deterioration. The challenge to each director is to exercise good leadership to avoid such a downward spiral of economic and political self-destruction.

Recipes for Success and Failure

From the legal standpoint, directors incur liability when they breach the standard of

care to which they are held under the statutory and case law which are discussed below. In reality, however, suits for breach of fiduciary duty can be viewed as arising from a lack of leadership and management skills by the board of directors. It is appropriate, therefore, to pause and consider the characteristics of successful leadership and management.

In successfully run homeowners associations, members of the board of directors possess good communication skills, carefully plan in advance, make good judgments based on sound decision making practices, delegate work to qualified committees or advisors, exercise initiative and independent thinking, and work well together as a team. In contrast, political or fiscal failures often result from the acts or omissions of boards of directors lacking good communication skills, procrastinating necessary work, making bad judgments without seeking input from committees or advisors, stagnating for lack of initiative, or political stalemates caused by dysfunctional personal relationships among the board members. From this perspective, the exercise of fiduciary duty flows naturally from effective business management, and it is the breakdown of good management practices, and the lack of skilled leadership, that breeds claims for breach of fiduciary duty.

What is Fiduciary Duty

Fiduciary duty is a standard of care which inheres in a legal relationship of trust and confidence between one in a position of power, dominance or authority, and another who is dependent on the proper exercise of that authority. Fiduciary duty exists in relationships between directors and their corporation, trustees and their trusts, and attorneys and their clients. Inherent in fiduciary duty is the responsibility to act in good faith and candor, the duty to act in the interests of another and to avoid self-dealing transactions, and the obligation to not exert undue pressure or to act without the knowledge and consent of the "beneficiary".

The law imposes fiduciary responsibilities to ensure that power is exercised responsibly. Directors are expected to act in the best interests of the corporation, and not to exploit their position of power for personal gain or advantage. No one argues with the soundness of this principle in the abstract. Experience demonstrates, however, that directors can become paralyzed in the stressful situation where the responsibility to act in the best interests of the corporation conflicts with personal or emotional needs, such as the basic human need for personal approval from one's neighbors and friends. Enforcing the governing instruments, properly funding the economic needs of the association, or pursuing causes of action for defective construction potentially place the director in the position of controversy and criticism. The good people who volunteer to serve their community through election or appointment to the board of directors are often unprepared for the emotional and political crossfires that can easily arise in the

performance of these duties. Even the anticipation of such controversy is sufficient to keep many directors from taking difficult short term actions that are important to the long term well being of the homeowners association.

Non-Profit Corporations Under California Law

California law actually varies the strict trustee standard of care for directors of non-profit mutual benefit corporations. For example, certain transactions between the director and the homeowners association may be valid even though a seated director has a material financial interest in the transaction. See, for example, Corporations Code Section 7233, imposing certain limitations on self-dealing transactions. However, self-dealing transactions are legally inadvisable although technically authorized under specific circumstances. They are also politically unwise and reflect poorly on the overall board of directors.

California law specifies a standard of care for corporate directors of non-profit mutual benefit corporations. Under Section 7231(a) of the Corporations Code, a director must perform his or her duties, including duties as a committee member, in good faith, in a manner the director believes to be in the best interests of the corporation, and with such care, including reasonable inquiry, as an ordinarily prudent person in like circumstances would use under similar circumstances. Compliance with this standard of care immunizes the director from legal liability for alleged failure to perform the individual's duty as a director. California law does not require that the director make what ultimately proves to be the "right" decision, only that the action be undertaken in good faith, in the manner the director believes to be in the best interest of the corporation, following reasonable inquiry, all to the extent that an ordinarily prudent person would use under similar circumstances in the conduct of business. However, the business judgment rule is not a shield against all liability. A director may be liable for acts or omissions, regardless of the director's honesty and good intentions, if the directors acts in ignorance without exercising reasonable inquiry, or simply acts without the prudence and skill of an ordinarily prudent person.

Beyond the business judgment rule incorporated in Section 7231, the Corporations Code provides even further legal protection under the "safe harbor" rule of Section 7231(b), if a director makes decisions in reliance on information, opinions, reports or statements by corporate officers or employees whom the director believes to be reliable and competent in the matter, or attorneys, accountants or others with respect to those matters in which the director believes such persons to be competent.

Further protection is given to directors of homeowners associations under Civil Code Section 1365.7. This statute provides that volunteer directors and officers have no liability, in excess of insurance, for bodily injury, emotional distress, wrongful death or

property damage, provided that the subdivision is exclusively residential, that the director has no developer or lender affiliation, that the director is either a tenant or owner of not more than two interests, that the director serves without compensation, that the act or omission was within the scope of the association duties of the officer or director, was performed in good faith, and was not willful, wanton or grossly negligent. A further condition for this immunity is that the association maintains general liability and errors and omissions insurance policies of One Million Dollars (\$1,000,000) or more if the subdivision has one hundred and one (101) interests or more, or alternatively at least Five Hundred Thousand Dollars (\$500,000) if one hundred (100) or fewer interests are involved.

Meeting the Test of Leadership - Underfunded Reserves

Aristotle recognized 2,000 years ago that an individual must have the virtues of courage and temperance to achieve the welfare of others. He wrote that courage means facing pain. The challenge of leadership in difficult situations is confronting one's neighbors and friends, imposing financial demands on oneself and one's neighbors, assuming the risk of failure in the controversy, and avoiding the lure of procrastination.

In the specific case of funding reserves, the director must remain focused on the best interests of the corporation. Loyalty to the corporation means subordinating personal objectives and needs to the financial requirements of the association. In this regard, Civil Code Section 1366 explicitly provides that the homeowners association shall levy regular and special assessments sufficient to perform its obligations under the governing documents and the Davis-Stirling Act, California Civil Code Section 1350 and following.

Where the financial needs of the association appear to be underfunded, directors may wish to engage a reserve study firm and a funding study preparer, to evaluate the major components which the association is obligated to maintain and repair, and determine appropriate sums for proper maintenance, repair and replacement in the future. Reliance on the advice of a committee, treasurer's report, accountant or reserve study expert in this regard will bring the director within the "safe harbor" protections of Corporations Code 7231(b). The critical test of leadership is moving from the stage of reasonable inquiry and deliberation to concrete action. This requires formulating and implementing a plan, after due consideration of legal funding options and alternatives, which might include regular assessment increases, special assessments with and without membership approval, and bank loans. The board must then educate the membership regarding the board's decision making process, and actively advocate the membership vote necessary to implement the board's plan.

Meeting the Test of Leadership - Construction Defects

Civil Code Section 1365.7(f)(1) specifically provides that the scope of duties of a director includes the decision concerning whether to conduct an investigation of the common area for latent defects prior to the expiration of the statute of limitations, and whether to sue the developer for defects in the design or construction of the project. The board's decision whether to investigate the common area for latent defects is one that should be made after exercising reasonable inquiry as required by Corporations Code Section 7231(a), and in reliance on the advice of special consultants, such as a forensic architect or engineer, and experienced legal counsel, as contemplated by Corporations Code Section 7231(b).

The Calderon pre-litigation alternative dispute resolution process, which is embodied in Civil Code Section 1375, is an important tool allowing the board to address design and construction problems and toll the statute of limitations without stigmatizing the subdivision with litigation. Under Civil Code Sections 1375 and 1368.4, the board does have a duty to inform the membership of design and construction problems known in the development, and alternatives available to address these problems. Importantly, the Davis-Stirling Act does not allow the board of directors to delegate to the members the ultimate decision concerning whether or not to file a lawsuit against the project developer for defects in design or construction. This remains the sole duty and responsibility of the board of directors as acknowledged in Civil Code Section 1365.7.

Documenting the Exercise of Fiduciary Duty

The importance of maintaining good sets of minutes of directors' meetings is well understood. Nevertheless, critical decisions of the board of directors which involve potential legal liabilities for the association or board, should be given particular attention when the minutes are drafted and approved. The board has an opportunity through the minutes to carefully record its exercise of fiduciary duty. For example, a resolution of the board of directors can specifically record the inquiry made by the board, the findings received, the qualifications of the consultants contacted, the board's reliance on the consultant's advice and recommendations, and considerations for and against the action which were evaluated by the board of directors.

The following resolution illustrates the types of findings which a board of directors may chose to make and record as part of a resolution to levy a special assessment to fund reserves through an emergency special assessment. The resolution acts as a road map to document the board's compliance with the business judgment rule under Corporations Code Section 7231.

Sample Resolution 97-15 of the Board of Directors of Green Acres HOA

Whereas, the Board of Directors retained AAA Reserve Study Preparers to conduct a visual examination of the components of the subdivision which the Association is responsible to maintain, repair and replace, as required by Civil Code Section 1365.5(e); and

Whereas, AAA Reserve Study Preparers issued a written report on June 1, 1997 which identified a potential collapse hazard on five decks located in Phase 1 of the Green Acres condominium project; and

Whereas, the Board finds on the basis of advice received from AAA Reserve Study Preparers that the cause of the collapse hazard is a severe termite infestation which occurred during the last three (3) years since the Association last engaged a termite inspection service to evaluate the common area for termites and dry rot; and

Whereas, the report of AAA Reserve Study Preparers is signed by a California licensed structural engineer; and

Whereas, the Board of Directors has discussed the findings of AAA Reserve Study Preparers with AAA Reserve Study Preparers' structural engineer and believes that AAA Reserve Study Preparers has the experience, skill, and judgment to make the findings and recommendations contained in its report; and

Whereas, the Board has appointed a committee of the Board to further inquire concerning the condition of these decks and received a written report of the committee dated July 1, 1997, agreeing with the recommendations of AAA Reserve Study Preparers; and

Whereas, the Board is responsible to maintain and repair deck structures under Article VI, Section 6.01(c) of the CC&Rs; and

Whereas, the Board of Directors has received advice from the Association's legal counsel concerning the circumstances under which the Board of Directors may levy an emergency assessment under California Civil Code Section 1366(b) and the Board has found that there is a threat to personal safety on the common area as a consequence of the potential collapse hazard of these decks; and

Whereas, Green Acres Homeowners Association does not have operating or reserve funds sufficient to repair said decks; and

Whereas, the Board has retained John T. Square, AIA & Associates to develop plans and specifications for the repair of the decks and said firm has a structural engineer in its employment and said architect and engineer have received stamped plans from the City approving proposed repair plans for the decks; and

Whereas, J. Able Construction Managers were retained by the Association to secure competitive bids for the repair of the decks, and competitive bids in the range of

\$100,000 to \$150,000 were received by the Association through J. Able Construction Managers; and

Whereas, it is also the opinion of the Board's consulting architect and engineer that the balconies must be repaired prior to the winter season of this year,

Now, therefore, the Board of Directors hereby levies a special assessment against the members of Green Acres Homeowners Association in the sum of One Thousand Dollars (\$1,000) per unit payable in full forty-five (45) days after the mailing of the notice of levy of the special assessment; and

Be it further resolved that a copy of this Resolution shall be included in the Notice of Levy which is to be mailed to the members; and

Be it further resolved that the Notice of Levy be mailed by Quality Management Company on behalf of the Board of Directors no later than September 1, 1997.

A resolution of this type documents the board's good faith in the decision, the basis for the action, the exercise of reasonable inquiry, and the reliance on the board of appropriately qualified consultants. It also specifies the legal basis for the board's action, which is particularly helpful in instances where the association's governing instruments are not current with applicable and superseding California statutory law. Please note that this resolution example is presented for discussion purposes only and the content of actual resolutions used by an association under these circumstances should be reviewed by the association's legal counsel.

The actions of the board must be taken at a duly noticed meeting at which a quorum is present. Civil Code Section 1363.05, the Common Interest Development Open Meeting Act, requires that members be allowed to attend and speak at all board meetings, except for executive session meetings which are limited to considerations of litigation, the formation of contracts with third parties, member discipline or personnel matters. This statute requires that members receive at least four (4) days advance notice of meetings, except for emergency meetings. The emergency meeting exception and executive session authorization are carefully circumscribed by the Davis-Stirling Act. The general labels of "executive session" and "emergency meeting" cannot be used to evade the rights of members to attend, observe and speak at director meetings, except in the limited instances authorized by the statute. Although the Davis-Stirling Act does not explicitly define the consequences of violating the Common Interest Development Open Meeting Act, arguably any action taken by the board at such a meeting is void or voidable.

Conclusion

By implementing good business management practices, boards of directors reduce the risk of legal claims for breach of fiduciary duty. Good leadership, planning, and team

work are fundamental ingredients for a successful homeowners association. Claims of fiduciary duty arise where a board procrastinates in taking necessary action to avoid the "unpleasantness" of the difficult decision confronting the board. The legal standards of conduct must be carefully followed, and the ultimate business judgment of the board should be documented in detail in a resolution with specific findings. Industry professionals and consultants can play key roles in guiding the board through challenging circumstances, such as underfunded reserves and the resolution of construction defects.

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