I know where you live — Directors and officers liability for residents associations

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Everyone wants to live in a nice neighborhood, where the landscape is maintained and common elements are taken care of. For many, the answer is ownership of a home in a condominium or cooperative association, or a home that is part of a homeowners association.

WHAT IS AN ASSOCIATION?

A condominium is a joint ownership of property where common elements or areas are commonly owned and the units are individually owned. It is created by record of a declaration of covenants and restrictions, bylaws, and a condo plat in the municipal land records or local county.

An HOA is comprised of homeowners living in private homes, and its purpose is to ensure the maintenance and provision of community facilities and enforcement of HOA covenants and restrictions.

It is created by record of a declaration of covenants, conditions and restrictions in local land records. Unlike at a condo association, an HOA's bylaws are not recorded in land records.

Generally, a condominium, HOA or other type of association is governed by the law of the state where it exists. For example, Florida condominium associations are generally governed by Chapter 718 of the Florida Statutes, while cooperative association requirements are set forth in Florida Statute Chapter 719, and HOAs are governed by Florida Statute Chapter 720.

It is natural for owners of these properties to want to be involved in their governing bodies. However, in today's litigious world, serving on a board of directors of this type comes with risks.

These risks are explored here, with an overview of best practices to avoid them while complying with the duties of board members.

The first step in assessing such risks — and avoiding them — is gaining a full understanding of the association's governing legal documents, such as bylaws, covenants, conditions and restrictions. These governing documents will inform prospective board members of the powers, responsibilities and potential liabilities that board membership entails.

Generally, the association has responsibility for its common elements, as well as the management and operation of the association's business affairs, all in accordance with standards established by the governing documents that were created when the community was first developed. Directors generally serve without compensation.

A board's authority generally allows all of the powers and duties provided in the state's general law, as long as those powers are consistent with the association's governing documents.

UNDERSTANDING FIDUCIARY DUTY

The first step in avoiding liability in connection with service on such a board is understanding the concept of "fiduciary duty" and knowing the fiduciary_obligations of board members.

> A board member must make informed decisions, and such decisions may require research and investigation before a vote is cast or decision is made.

These duties emanate from state corporate law.

Most associations are nonprofit corporations, and they are typically formed by filing articles of incorporation in the state where the development is located.

Recognizing that a corporation's board members serve in a position of trust, every state's corporation law imposes a fiduciary duty on the corporation's board of directors, requiring them to act in the best interest of the corporation.

Generally, this fiduciary duty applies to associations even though they are usually nonprofit corporations and even though the board members typically are volunteers.

The member's fiduciary duties generally involve three basic elements: the duty of care, the duty of loyalty and the duty to act within the scope of their authority.

The duty of care

Board members must make informed decisions. Such decisions may require research and investigation before a vote is cast or decision is made. As an example, board members must acquire knowledge of the association's rules and regulations before making decisions relating to violations.

Personal preference or choice must not be the reason for imposing a fine or deciding that a violation has occurred.

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The duty of loyalty

The duty of loyalty means that board members must act fairly and in good faith, with the interest of — and for the benefit of — the association as a whole. Personal interest or gain cannot influence a decision, and where such personal interest or gain could be an issue the board member must generally abstain from any involvement in the matter.

Next, a board member must protect members' confidentiality and not divulge information provided in confidence.

The duty to act within the scope of authority

Board members must perform their duties while acting within the scope of their authority. This authority is generally granted and limited by state laws and by the development's governing documents.

Again, the "know your documents" rule comes into play. Review your state law and the HOA's governing documents, i.e. the articles of incorporation and bylaws, and your development's rules.

COMMON CLAIMS

Even after doing all this, and being aware of their fiduciary duties, board members may find themselves on the wrong side of a lawsuit.

According to a recent study of actions nationwide against association boards, the most common claims are:

- Failure to adhere to bylaws.
- Failure to properly notice elections.
- Failure to properly count votes/proxies.
- Challenges by members regarding power granted the board by bylaws.
- Improper removal of board members.
- Liability for board decisions resulting in physical damage to the association's property.
- Challenges to assessments.
- Challenges to approval of variances, generally by an architecture committee.
- Breach of fiduciary duty.
- Challenges to decisions of an architectural review board.
- Questions or challenges regarding easements/penalties .
- Failure to maintain common areas.
- Failure to properly disburse funds (i.e. insurance proceeds).
- Defamation by a board of a member.[1]

Based on these top causes of action against association boards, claims generally fall into two groups: failure to abide by governing documents, and breaches of fiduciary duty.

As to the first group, boards not only often fail to know or follow the governing documents; they also sometimes fail to formalize changes and amendments. Even when board members understand and follow governing documents, those documents can cause problems if they are inaccurate or do not comply with state law.

Most states have significantly updated laws that govern community associations. These changes will often conflict with an association's governing documents, particularly ones that have aged significantly without a competent lawyer's review for compliance with state law.

A related problem occurs when an association fails to formally amend changes to its governing documents. Even when an association's rules comply with state law, board action may be deemed improper if the authority and rationale for the board to act is not properly authorized and memorialized in the association's governing documents.

Thus, board members must always be aware of what authority the association's rules and regulations vests in the board — and be vigilant not to exceed those powers.

NOTICE REQUIREMENTS

State law will generally govern the means and methods by which notice must be given for meetings and points of decision-making in the operation of the association and board.

For example, in Florida — the condominium epicenter of the nation — Section 718.112(2)(c) of the Florida Condominium Act provides that notice of all board meetings must specifically identify agenda items and must be posted conspicuously on the condominium property at least 48 hours before the meeting, except in an emergency.

The statute also requires that written notice be given of any board meeting at which nonemergency special assessments, amendments to rules regarding unit use, the association budget or insurance deductibles will be considered.

The notice must be mailed, delivered or electronically transmitted to the unit owners, and it must also be posted conspicuously on the condominium property not less than 14 days before the meeting.[2]

Some bylaws may require even more notice. But in all cases, the more notice that is given the better, particularly where assessments or other financial matters are being considered.

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SHOW ME THE MONEY

As in most things, money and its control is a major problem area for association boards.

Associations are driven by accounting and budgets. Generally the rules will allow the association to collect revenue from its members. Thus, those members are usually watchful as to how their money is spent.

In the best-case scenario, everything is transparent. In all cases, the governing documents must clearly set forth the manner of collection, use, voting requirements for such use, and accounting of all monies.

Many claims may be avoided if two principles are followed: transparency, while following state law, so that all members of the association can see how money is collected, safeguarded and used, and clear and uncomplicated rules and regulations within the association documents and bylaws that govern all financial aspects of revenue.

DERIVATIVE CLAIMS

Money, or more properly, an allegation that the board failed to keep an eye on it, resulted in a ruling that expanded the manner in which a board can be sued.

In *Davis v. Dyson*, 387 Ill. App. 3d 676 (Ill. App. Ct., 1st Dist. 2008), 12 condo owners in Chicago sued the former board after the board members failed to detect embezzlement by an outside property manager.

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What sets this case apart is that the court found the owners could sue their directors in a derivative lawsuit. In the derivative claim, the owners alleged on behalf of the association that the directors' failures harmed their property values.

The board countered that only the board itself may bring a derivative action against third parties. The trial court agreed and dismissed.

On appeal, the Illinois Appellate Court said since shareholders generally have an undisputed right to sue their own boards, the derivative action against an association was allowable because a derivative suit puts homeowners into the association's shoes. The court also ruled that the action did not run afoul of the Illinois Condominium Property Act.

Another interesting wrinkle in the matter was that the owners alleged the former board members failed to secure adequate insurance or an attorney's advice, resulting in losses and out-of-pocket costs of nearly $800,000.

INSURANCE ISSUES

When deciding whether to serve on a board, a critical first step is to make sure the board not only has insurance but has the right type of insurance.

A proper directors-and-officers liability policy covers past as well as present board members, property managers, employees and volunteers, in addition to the association itself. Many carriers provide a vast range of coverages.

Generally, stand-alone D&O policies are broader and afford more coverage than policies that are merely a component of the association's commercial liability policy.

Anyone interested in serving on a board should closely review the association's coverage. Moreover, it is a best practice to review the coverage yearly with the association's attorney and insurance agent, not simply for price but also to explore what broader coverages may have entered the market where your association operates.

HOW THE BOARD WORKS

Generally, boards have the right to establish reasonable regulations concerning procedures for speaking at meetings.

Again, state law will point the way, but generally, requests for speakers to sign in, or submit paperwork, in advance of meetings is acceptable, as is providing reasonable time limits for all speakers — as long as those time limits are uniformly enforced. General practice indicates that three to five minutes is appropriate for each speaker.

State law will generally require boards to keep minutes of all meetings and proceedings. However, remember that the purpose of minutes is to record what was done, not what was said. Board resolutions that include findings of fact must be recorded in the minutes.

Typically the minutes will memorialize the date, time and location of the meeting, as well as the presiding officer. Next, proof that a quorum was present, including a list of attendees, is required.

The proof of proper notice for the meeting, as well as acceptance or rejection of prior minutes, should be reflected in the minutes. Thereafter, the minutes should reflect, in summary form and in a manner that enables review by a third party, any reports that were given and decisions that were made.

CONCLUSION

Being on a board is a great responsibility. That is why it is important to know the rules, regulations and state laws that govern the operation of associations in your state. Partnering with a legal professional who is experienced in association law is key.

With the knowledge of the law of the state and the rules of the association, a board membership can be a rewarding endeavor that adds to the value of homeownership. WJ

NOTES

[1] *Top Ten Most Common D&O Insurance Claims (I),* Ian H. Graham Ins., http://www.ihginsurance.com/Pages/Top-Ten-Most-Common-DO-Insurance-Claims.aspx (last visited Aug. 28, 2017).

[2] State law may provide exceptions to the requirement for open meetings. As an example, Section 718.112(2)(c)(3) of the Florida Condominium Act provides an exception for meetings between the board or a committee and the association's attorney with respect to "proposed or pending litigation," if the meeting is held for the purpose of "seeking or rendering legal advice." Similarly, an exception is provided under Section 718.112(2)(c)3 of the Florida Condominium Act if the board is going to discuss "personnel matters."

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