



Homeowners Associations and the Business Judgment Rule: Bad Law

Should the business judgment rule (herein “BJR”) rather than the alternative, reasonableness test for decision-making be the standard for HOA board actions? The courts grant HOA boards broad rights over homeowners by currently holding that the board is the best decider of what's good for the HOA, not the courts, regardless of any test of the reasonableness of actions. We believe that the rationale for this position was reached by faulty analysis and a bias toward treating the HOA government as the best arbiter of “the stability of the common living arrangement.”

We believe this holding deprives homeowners of their due process rights, especially when board decisions relate to rules and regulations regarding use of private property and the conduct of the homeowner.

The 2003 Johnson opinion, Arizona appellate, differs from the other earlier cases cited below. The following citations will appear confusing or conflicting, but that is the nature of the law. In some decisions in favor of deference, look for key words like “arbitrary and capricious”, “good faith”, “public policy” and “best interests”. Homeowners must be aware of the court rulings giving deference to board's decision-making, and the fact that they agreed to the broad powers given the HOA.¹

Please note the frequent citations of the Lamden case, in which there was a strong “lobbying” effort by CAI member attorneys and CAI itself. (See D, Cases, below).

A. THE COURT RECORD

a. BJR justification, from Lamden (emphasis added)

"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 is the organization's best interest. A hallmark of the business judgment rule is that, **when the rule's requirements are met, a court will not substitute its judgment for that of the corporation's board of directors.** (See generally, Katz v. Chevron Corp. (1994) 22 Cal.App.4th 1352)."

"The business judgment rule has been justified primarily on two grounds. First, that directors should be given wide latitude in their handling of corporate affairs **because the hindsight of the judicial process is an imperfect device for evaluating business decisions.** Second, [t]he rule recognizes that **shareholders to a very real degree voluntarily undertake the risk of bad**

¹ See last page for Legal Disclaimer.

business judgment; investors need not buy stock, for investment markets offer an array of opportunities less vulnerable to mistakes in judgment by corporate officers.' (Frances T., supra, 42 Cal.3d at p. 507 (1986), fn. 14, quoting 18B Am.Jur.2d (1985) Corporations, § 1704).” [Justification in applying BJR was that the condo association performed business functions like a landlord].

The court shows it bias with, “*a differential business judgment rule’ or a more intrusive one of ‘objective reasonableness’*”.

b. “Reasonableness standard” in Nahrstedt

“Although no one definition of the term ‘reasonable’ has gained universal acceptance, most courts have applied what one commentator calls ‘**equitable reasonableness, upholding only those restrictions that provide a reasonable means to further the collective ‘health, happiness and enjoyment of life’ of owners of a common interest development.** (Note, Business Judgment, supra , 64 Chi.- Kent L.Rev. at p. 655.) Others would limit the ‘reasonableness’ standard only to those restrictions adopted by majority vote of the homeowners or enacted under the rulemaking power of an association's governing board, and would not apply this test to restrictions included in a planned development project's recorded declaration or master deed. Because such restrictions are presumptively valid, these authorities would enforce them regardless of reasonableness.”

“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.”

“In Hidden Harbour Estates v. Basso (Fla.Dist.Ct.App. 1981) 393 So.2d 637, the Florida court distinguished two categories of use restrictions: use restrictions set forth in the declaration or master deed of the condominium project itself, and rules promulgated by the governing board of the condominium owners association or the board's interpretation of a rule. (Id. at p. 639.) **The latter category of use restrictions, the court said, should be subject to a "reasonableness" test, so as to ‘somewhat fetter the discretion of the board of directors.’** (Id. at p. 640.) Such a standard, the court explained, best assures that governing boards will "enact rules and make **decisions that are reasonably related to the promotion of the health, happiness and peace of mind' of the project owners, considered collectively.** “

”By contrast, **restrictions contained in the declaration or master deed of the condominium complex, the Florida court concluded, should not be evaluated under a ‘reasonableness’ standard.** (Hidden Harbour Estates v. Basso, supra, 393 So.2d.) Rather, such use restrictions are "clothed with a very strong presumption of validity" and **should be upheld even if they exhibit some degree of unreasonableness. Nonenforcement would be proper only if such restrictions were arbitrary or in violation of public policy or some fundamental constitutional right.”**

“**Generally, courts will uphold decisions made by the governing board of an owners association** so long as they represent good faith efforts to further the purposes of the common interest development, are consistent with the development's governing documents, and comply with **public policy.** 51 Ohio St. L.J. at p. 43.”

c. **Preferred BJR in Levandusky, (emphasis added)**

“As courts and commentators have noted, the cooperative or condominium association is a quasi-government – a ‘little democratic sub society of necessity’ (Hidden Harbour Estates v. Norman, 309 So.2d 180).”

“[T]his reasonableness standard – originating in the quite different world of government agency decisionmaking has found favor with courts reviewing board decisions.... **The more limited judicial review embodied in the business judgment rule is preferable.** In the context of the decisions of a **for-profit corporation**, ‘courts are ill equipped and infrequently called on to evaluate what are and must be essentially business judgments ...’

d. **Rejecting BJR in Johnson, an Arizona ruling (emphasis added),**

“The court defers to the decisions of others only in limited circumstances. For example, if parties have provided for dispute resolution ... Similarly, the superior court will uphold the determinations of a state administrative agency”

“(citing *Divizio v. Kewin Enters., Inc.*, 136 Ariz. 476, 481, 666 P.2d 1085, 1090 (App. 1983)). The interpretation of restrictive covenants is a question of law for the court. *Id.* (‘The interpretation of a contract is a matter of law and not a question of fact.’). **In interpreting the meaning of a covenant, the superior court does not defer to the interpretation given by the association.**”

“In the absence of declaration provisions providing alternative means of resolving disputes arising from the enforcement of restrictive covenants, **both homeowners and their associations are entitled to bring their case before the courts without either party’s position receiving deference.** The civil courts afford a neutral interpretation of the development’s declaration and ‘significant protection against overreaching’ by either homeowners or their association. *See Lamden*, 980 P.2d at 952.”

“Because of its considerable power in managing and regulating a common interest development, **the governing board of an owners association must guard against the potential for the abuse** of that power. *Nahrstedt v. Lakeside Village Condo. Ass’n.*”

"Thus, while Lamden protects the discretion to act given to a governing association by its declaration, **Lamden does not even infer that an association’s interpretation of its own restrictive covenants in a dispute with a homeowner is entitled to deference from the superior court.** Such deference is inappropriate. ... {citing *Divizio v. Kewin Enters., Inc.*, 136 Ariz. 476, 481, 666 P.2d 1085, 1090 (App. 1983)}. **The interpretation of restrictive covenants is a question of law for the court.**"

“**[T]he superior court erred when it gave deference to the determinations of the Association in entering judgment on behalf of Defendants.**”

e. **In Lamden (emphasis added)**

"As will appear, we conclude as follows: Where a duly constituted community association board, upon reasonable investigation, in good faith and with regard for the best interests of the community association and its members, exercises discretion within the scope of its authority under relevant statutes, covenants and restrictions to select among means for discharging an

obligation to maintain and repair a development's common areas, courts should defer to the board's authority and presumed expertise. [analogizing a similarly deferential rule to the common law 'business judgment rule'"]

"[Citing appellate court opinion in this case, which was overruled]. Ultimately, the [trial] court gave judgment for the Association, applying what it called a "business judgment test." Lamden appealed. In the Court of Appeal's view, relevant statutes, the governing Declaration and principles of common law imposed on the Association an objective duty of reasonable care in repairing and maintaining the Development's common areas near Lamden's unit as occasioned by the presence of termites. **The court also concluded that, had the trial court analyzed the Association's actions under an objective standard of reasonableness, an outcome more favorable to Lamden likely would have resulted.** Accordingly, the Court of Appeal reversed the judgment of the trial court."

"We declared in Nahrstedt that, "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."

"Ironwood Owners Assn. IX [21 Cal.4th 266] v. Solomon, supra , 178 Cal.App.3d at p. 772 [holding homeowners association seeking to enforce CC&R's and compel act by member owner must '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']".

"In Nahrstedt we emphasized that anyone 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.' "

f. In Johnson, HOA not entitled to agency deference (emphasis added):

"Similarly, the superior court will uphold the determinations of a state administrative agency 'unless after reviewing the administrative record and supplementing evidence presented at [an] evidentiary hearing the court concludes **that the action is not supported by substantial evidence, is contrary to law, is arbitrary and capricious or is an abuse of discretion**'. See, e.g., Riss v. Angel, 912 P.2d 1028, 1033 (Wash. Ct. App. 1996) (**determinations of homeowners board not entitled to deference under state administrative procedures act**)".

B. The Case for a Reasonableness standard for HOA actions

a. Duty of care, reasonable man, and tort law.

A careful examination of the above rulings leads to the absurd conclusion that an HOA board may act in an unreasonable manner, reach an unreasonable decision, as long as it acted in good faith, didn't violate the governing documents, acted in the best interests of the community, and "upon reasonable investigation" only (see paragraph 1 in "c" above). The court speaks of risks to justify the application of a business judgment standard rather than the standard in negligence, reasonableness (see paragraph 2 in "a" above). But, tort law already deals with risks and unreasonable behavior,

“[Negligence] has been defined a ‘conduct which involves an unreasonable great risk of causing damage’ ... which falls below the standard established by law for the protection of others against unreasonable risk of harm” (Unreasonable Risk, § 31, Prosser and Keeton On Torts, West 5th ed., 2004, citing Restatement (Second) of Torts §282).

And the standard used is that of a reasonable person. It is a flexible standard, unlike the absolute “whatever they do is OK regardless of the circumstances” of the business judgment rule. It must be a flexible standard to apply an expected conduct under the specific circumstances.

“The conduct of the reasonable person will vary with the situation with which he is confronted. The jury must therefore be instructed to take the circumstances into account; negligence is a failure to do what the reasonable person would do ‘under the same or similar circumstances’” (Prosser, *The Reasonable Person*, § 32).

And let us not forget the use of the “beyond a reasonable doubt” criteria for guilty verdicts in criminal trials.

b. HOA is not a business

It is understandable that the courts should not be put into the position of a “shadow board” of a business board of directors. The courts should not get involved. Consequently, to escape involvement in HOA governance of a community, not a business, the court has opted to treat the HOA as a business, implying that the homeowner, like a business shareholder, has an understanding of the risks involved and that decisions will not always be in their favor of a bona fide business enterprise. (See C, Definitions, below).

But the HOA is not a business, an entity organized to make a profit, even if it conducts business functions. Why not consider the HOA as a government entity since it, like a municipality, has some business functions? Like a municipality, the HOA sells no product or service, as a bona fide business entity must do, but relies on assessments -- member mandatory taxes -- for its revenues, and is not allowed to make a profit for its owner-members.

c. HOA boards and greater wisdom

In its rulings, the courts have attributed a greater wisdom to the HOA board, which greatly varies from the reality of drafted volunteer directors and directors with a personal agenda. It applies another set of laws upon homeowners living in an HOA who were sold the concept of a vibrant, healthy community maintained by an HOA, and not that they were buying into a business with their home as collateral (the HOA right to foreclosure places their home as collateral for the continued payment of assessments). HOA directors do not have to show any particular educational achievements or licensing, or experience resume, or any “moving up the ladder” as qualifications for the highly desirable position of board director. In fact, HOA directors are more like our elected officials than business executives. While even nonprofit board candidates must show some qualifications, HOA board members need only to offer their bodies at the board meeting, with no more than three consecutive absences in many cases.

Events over the past 15 years attest that, for the most part, the same problems still exist with the operation and conduct of HOAs that are marketed as leading to and producing healthy, vibrant communities. (See below: Neighborhood Politics (1992), Privatopia (1994), and Common

Interest Communities (1994)). With these continued problems, HOA boards fail to exhibit a greater wisdom, or the HOA form of private government is defective and a failure.

d. Objections to business judgment rule

Industry attorneys and supporters have dominated the planned community and homeowners association area of law. A homeowner's view of the business judgment rule can be found in the fairly recent publication, *California Common Interest Development: Homeowner's Guide*, Donie Vanitzian (West 2006). Sections 5:22 to 5:26 carry an analysis of this rule.

In "Directors' Individual Liability", § 5:21, the author reminds the reader that the HOA is not a business:

"Homeowners associations are simply not businesses in the classical or statutory sense of the word 'business'.... Reliance on the business judgment rule in determining whether or not an association's board has acted legally ignores the fact that the board, as a non-profit corporation, was formed not to run a business Nothing in the development documentation states that the association or its minions are directed to make a profit or increase the value of the property."

e. Objections to reasonableness

What is objectionable to the standard of "reasonableness", a standard test in tort law in deciding wrongful behavior? After a lengthy discussion of tort law and tenant-landlord duty of care, the Lamden court concluded, "*Contrary to the Court of Appeal, however, we do not believe **this case implicates such duties***" (emphasis added).

The Levandusky court rationalized,

"Allowing an owner who is simply dissatisfied with particular board action a second opportunity to reopen the matter completely before a court, which – generally without knowing the property – may or may not agree with the reasonableness of the board's determination, **threatens the stability of the common living arrangement.**"

This is another biased ruling that presupposes that the homeowner is "simply dissatisfied" and for example, not alleging damages and a loss of rights by an unreasonable behavior by the board, and not entitled to his right to due process before the courts. It essentially says that the board can never legally act in an unreasonable manner, that the board is untouchable and without error, and that there is no need for a homeowner to protect his home by means of the equal protection of the laws, and the reasonableness test of tort law and negligence. This deference rises to the level of treating the HOA as an absolute monarchy, a dictatorship, or a Roman Emperor, all above the law.

The courts have repeatedly echoed their concern about a privately contracted HOA government's stability, regardless of that the fact that the HOA offers no bill of rights and operates outside the 14th amendment. The allegations by homeowners against boards are many times no different from a complaint against another person or entity, like when neighborhood ordinances come into play, laws that are nothing more than municipal rules and regulations themselves. And the municipal, the justice and superior courts deal with as part of its obligations under state

constitutions. Even with government agencies, negligence is not acceptable behavior, if gross negligence occurs. Yet, the homeowner is denied even this level of protection afforded against our government agencies!

The courts have confused the actions of a reasonable act versus actions “reasonably related to” or as a “reasonable means to further” the objectives of the HOA. Requiring a specified dimension for any modification to landscaping, say gates or plants, would be upheld as reasonably related to the purposes of the HOA, since some limitation must be set. But would it be a reasonable decision to require a gate, for example, to be 3 feet 8 inches high and not 3 feet 9 or 3 feet 7 inches high? Or only red roses, but not bougainvillea (another red flower)? Would such a variance have a negative affect on property values? On the aesthetics of the community? The answer would generally be “no”, unless the HOA is characterized as having an obsessive compulsion about uniformity.

f. Conclusions

The business judgment rule, or any variation of it, is the wrong standard to measure wrongful behavior by HOA boards that have a fiduciary duty to the homeowners. It is an act of madness not to hold HOA board members to the standard of care and duty as expected of any reasonable person. **It is bad law!** It deprives a homeowner in an HOA from the due process he would have received if he had violated a municipality rule and regulation, an ordinance.

Furthermore, in a bona fide business, an unreasonable action by the board does not place the shareholder at risk of losing his home or subjecting him to financial hardships in terms of fines and liens on his home. He sells his shares, if a public business, or hopes to sell his private shares back to the other business owners.

C. Definitions (Black’s Law Dictionary)

Business: A commercial enterprise carried on for profit.

Common law: The body of law derived from judicial decisions, rather than from statutes or constitutions.

Common law jurisdiction: In absence of a controlling statute, the court exercises common-law jurisdiction over claims.

Fiduciary: One who owes to another the duties of good faith, trust, confidence, and candor.

Good faith: A state of mind consisting in (1) honesty in belief or purpose, (2) faithfulness to one’s duty or obligation, (3) observance of commercial standards of fair dealing in a trade or business, or (4) absence of intent to defraud or to seek unconscionable advantage.

D. CASES

Arizona

Johnson v. The Pointe Community Assn., Inc., CA-CV 02-0160 (Ariz. App. Div. 1 2003) (court does not give deference to HOA board)(Mulcahy Law firm for the HOA).

California

Lamden v. La Jolla Shores Clubdominium Homeowners Assn., 980 P.2d 940 (Cal. 4th 1999) (court deference to board judgment; business judgment rule)(CAI CCAL members Sproul and Freedman wrote amicus curiae briefs, and CAI submitted its own for defendants)..

Nahrstedt v. Lakeside Village Condominium Association, 878 P.2d 1275 (1994) 8 Cal.4th 361 (covenants & public policy).

New York

Levandusky v. One Fifth Ave. Apartment Corp., 75 N.Y.2d 530 (1990)(cooperative apartments).

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