

# RECENT TRENDS IN THE BUSINESS JUDGMENT RULE AND OTHER STANDARDS OF REVIEW

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## I. Introduction

Community association attorneys are regularly called upon to help clients determine whether their processes, decisions and conduct are “proper,” “legal,” “defensible” or “likely to be upheld” if subjected to judicial scrutiny. Guiding our clients requires an assessment of the contexts in which challenges to board authority arise and the legal standards courts will apply to sustain, “reverse” or penalize the exercise of that authority.

One common standard familiar to practitioners is the “business judgment rule” which, typically applied in the “for profit” legal environment, essentially says that business decisions made in good faith by sufficiently informed, disinterested directors should not be undone by subsequent judicial review. The business judgment principle fits awkwardly into the community association model where decision making involves more than the assessment of commercial risks with consequences frequently different than financial gain or loss and where those making the decisions lack specialized expertise or complete “disinterest” in an outcome. Further, while it may make sense to apply a business risk/benefit model to maintenance or financial challenges facing a board, the judicial deference that might otherwise apply is not necessarily compatible with the way courts construe recorded covenants.

This article explores current statutory and judicial trends dealing with the business judgment rule, judicial deference and to a lesser extent “reasonableness” limitations on association and board conduct, business or otherwise; this discussion is not comprehensive but illustrative of the rationale employed by courts in passing on the kinds of challenges familiar to attorneys whose practices emphasize representation of community associations.<sup>1</sup> Likewise, not dealt with here are the interesting theoretical questions of whether and to what extent corporate, governmental, constitutional or other standards, alone or in combination, ought apply to board decisions or governing document enforcement.<sup>2</sup> While the cases, depending on the facts and jurisdictions, apply several standards for deferring or not to association and board behavior, all suggest practical considerations which can aid counsel in helping their clients be better prepared for challenges to their conduct. These considerations are discussed in the last section of this article.

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<sup>1</sup> Many law review articles address the standards by which appellate courts judge covenants and decisions implementing them. See, for example: Goldberg, *Community Association Use Restrictions: Applying the Business Judgment Doctrine*, 64 Chi-Kent L. Rev 653 (1988); Hyatt, *Common Interest Communities: Evolution and Reinvention*, 31J. Marshall Law Rev. 303 (1998); Note, *The Rule of Law in Residential Associations*, 99 Harv. L. Rev 472 (1985); Note, *Judicial Review of Condominium Rulemaking*, 94 Harv. L. Rev. 647 (1981).

<sup>2</sup> See, for example, Franzese, *Common Interest Communities: Standards of Review and Review of Standards*, 2 Wash. U.L. & Poly 663 (2000); Hyatt, *The Business Judgment Rule and Community Associations: Recasting the Imperfect Analogy*, 1 *Journal of Community Association Law* 2 (1998) and the articles identified in footnote 1.

## II. Statutory Framework

The Restatement codifies the business judgment rule by requiring association directors and officers to act in good faith, in compliance with state laws and the Association's governing documents; directors are also required to "deal fairly" with the Association and its members and to "use ordinary care and prudence in performing their functions."<sup>3</sup> Under the Uniform Common Interest Ownership Act of 1994 ("UCIOA") directors are subject to the traditional corporate model: "Officers and members of the executive board not appointed by the declarant shall exercise the degree of care and loyalty required of an officer or director of a corporation organized...(under the state non profit corporation law in the state which adopts the Act)."<sup>4</sup> Comments to UCIOA Section 3-103(a) explain that the duty should parallel that applicable to state standards imposed on directors of non profit corporations which garners for the members the "benefits of the business judgment rule now commonly applied by courts in the non profit context."<sup>5</sup>

Nevada, hosting this year's annual CAI law conference, adopted UCIOA and its version of the business judgment statute<sup>6</sup> is not dissimilar to what is found in other states; it explicitly imposes on directors a "status" as fiduciaries but again makes (or appears to make) their standard of care one of reasonableness: "In the performance of their duties, the officers and members of the executive board are fiduciaries. The members of the executive board are required to exercise the ordinary and reasonable care of directors of a corporation, subject to the business-judgment rule." Likewise, Oregon's statute requires directors to act "in good faith" and "with the care an ordinarily prudent person" would exercise "in a manner the director reasonably believes" to be in the association's best interest.<sup>7</sup>

California has not embraced UCIOA but instead adopted its own extensive regulatory scheme, the Davis-Stirling Common Interest Development Act.<sup>8</sup> It approaches the issue somewhat differently than does UCIOA by coupling adherence to a specified standard of care with its reward: qualified, limited immunity for volunteer directors (but not the Association itself). Immunity from tort damage awards to the extent of insurance is given so long as conduct is made in good faith, within the scope of the director's duties and provided mandated levels of insurance are maintained.<sup>9</sup> Like UCIOA, the California statute is not intended to protect decisions or conduct made by declarant directors.<sup>10</sup> Unlike the California statutory scheme, UCIOA does not explicitly vest directors with immunity for claims arising out of their "business judgment" or otherwise.

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<sup>3</sup> Restatement Third of Property: Servitudes, Section 6.14; also see Section 6.13 requiring the *Association* to use ordinary care and prudence in managing the property, to treat members fairly and to act reasonably in exercising discretionary powers.

<sup>4</sup> Section 3-103(a). As of 2000, the Act or its predecessors, was operative in twenty-three states. See Note, *Remedies for Common Interest Development Rule Violations* Colum. L. Rev 1958, 1973, n. 103 (2001).

<sup>5</sup> Comment 6.

<sup>6</sup> NRS Section 116.3103(1).

<sup>7</sup> ORS Section 65.357.

<sup>8</sup> California Civil Code Sections 1350 et. seq.

<sup>9</sup> California Civil Code Section 1365.7.

<sup>10</sup> California Civil Section 1365.7(c). For that matter, the immunity does not protect owners of more than 2 separate interests in the development. Under UCIOA, declarant directors are subject to a "trustee" (i.e., higher) standard of care and not merely the business judgment standard. See Section 3-103(a) and the accompanying note 6. California Civil Code Section 1365.7. The statute notably strikes a balance between encouraging volunteerism, a "good faith" standard of care and the compensation of victims (by requiring the Association to maintain \$500,000 or for communities larger than 100 separate interests, \$1 Million) injured by negligent, but not grossly negligent, director error.

### III. Judicial Philosophy

Historically, courts applied the business judgment rule in a relatively narrow context:

“The business judgment rule insulates an officer or director of a corporation from liability for a business decision made in good faith if he is not interested in the subject matter of the business judgment, is informed with respect to the subject of the business judgment to the extent he reasonably believes to be appropriate under the circumstances, and rationally believes that the business judgment is in the best interests of the corporation.”<sup>11</sup> (underline added)

In community association jurisprudence, the rule is construed more comprehensively. It serves not only as a “shield” to protect *directors* but it and the related business judgment “doctrine” have been expanded to justify board *decisions* and to defend the *associations* on whose behalf those decisions are made.<sup>12</sup> Decisions referenced in this article thus involve claims against directors, unincorporated associations and their members and those concerning the implementation and interpretation of recorded covenants and rules.

Owing to the myriad approaches and statutory frames extant throughout the country, it is hard to articulate one guiding principle that determines whether a particular court will expressly or implicitly adopt a species of “business judgment” rule deference. According to the Restatement Reporter:

“Case law governing the liability of associations to members and the ability of common interest community members to challenge actions of the association tends to be somewhat confusing and unsatisfactory, in part because there is a tendency to lump together several different questions for treatment under a single rule. In recent years, a number of state courts have decided community association cases by adopting either the “reasonableness rule” or the “business judgment rule.” Although these two “rules” are discussed as if they were substantively different, they appear to allow the same challenges to association actions. Under either rule, common interest community members are entitled to judicial review of claims that association actions are *ultra vires*, are made in bad faith, or are made by interested directors, or that the actions are arbitrary, capricious, or discriminatory.”<sup>13</sup>

The trend of the cases reveals that where their resolution depends on questions involving the type of expertise judges are trained for and familiar with, they will not defer to conduct or interpretations engaged in or adopted by boards of directors; on the other hand, where the issues turn on questions within the purview of the expertise or “local” experience of lay directors or involve the execution of

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<sup>11</sup> *Cuker v Mikalauskas*, 692 A2d 1042, 1045 (1997) quoted by Wayne S. Hyatt, *The Business Judgment Rule and Community Associations: Recasting the Imperfect Analogy*, 1 *Journal of Community Association Law* 2, 3 (1998).

<sup>12</sup> Wayne S. Hyatt, *Condominium and Homeowner Association Practice: Community Association Law* (3<sup>rd</sup> Ed.) Section 5.03(b); Note, *Judicial Review of Condominium Rulemaking*, 94 *Harv. L. Rev* 647, 665 (1981).

<sup>13</sup> Restatement Third Property: Servitudes, Section 6.13, com. a pp. 328-329. Perhaps it is the complex nature of the relationship between the association, board and members that creates the lack of clarity and easy to follow standards: “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.” All citations omitted. *Ostayan v Norhoff Townhomes Homeowners Association* (2003) 110 Cal. App 4<sup>th</sup> 120, 127-128, discussed *infra*.

authorization properly and fairly given the association by governing documents, statutes or membership approval, courts will not interfere based on either a board's "business judgment," notions of "judicial deference" or because the conduct challenged is characterized as reasonably related to the association's core purposes.

#### IV. Business Judgment, Deference and "Reasonableness" Applied

Cases in which a board's business judgment is most likely to be sustained concern disputes over the manner in which a board executes its responsibility to maintain common property. For example, in refusing to permit a challenge to a board's common area repair plan over one demanded by a litigious owner, a New York intermediate appellate court did not question the wisdom of adopting and implementation of the association's maintenance responsibilities saying:

"where a challenge is made by an individual owner to an action of a (condominium) board...absent claims of fraud, self-dealing, unconscionability or other misconduct, the court should apply the business-judgment rule and should limit its inquiry to whether the (board's) action was authorized, taken in good faith and in furtherance of the legitimate interests of the condominium."<sup>14</sup>

This same principle was applied in a leading California case involving an unincorporated condominium association afflicted with termites, *Lamden v La Jolla Shores Clubdominium Association*.<sup>15</sup> There, the Supreme Court adopted a judicial deference standard which did not weigh whether the board's limited spot spraying treatment plan was better than the global "tenting" approach urged by a member (and supported by her experts); instead the court held that deference was appropriate where the board's exercise of discretion in selecting repair methodologies was "clearly" within the scope of its authority and directors acted in good faith, upon reasonable investigation and with regard to the best interests of the community.<sup>16</sup>

When the authority to act is clear, whether in the "business" or "building care" context, courts are less likely to interfere with an association's internal operations. In a case cited (though not always followed) in many jurisdictions, *Levandusky v One Fifth Avenue Apartment Corp.*, the highest New York court adopted the business judgment doctrine by refusing to overturn the board's refusal to permit an internal architectural building modification requested by an owner. The plan to relocate heating pipes was prohibited by rule and rejected by the board (no exceptions to the rule had previously been made); prior to denying the proposed modification, the directors conferred with a qualified engineer who confirmed that while relocation was feasible and would not necessarily cause problems, any change in old piping systems presented risks that should be avoided where possible.<sup>17</sup> Presumably the board could have approved relocation (perhaps coupled with the posting of a deposit and an indemnity agreement for damage resulting from the modification) but its decision not to do so was within its discretionary power: "...the responsibility for business judgments must rest with the corporate directors; their individual capabilities

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<sup>14</sup> *Schoninger v Yardarm Beach Homeowners Association*, 523 N.Y.S. 2d 523 (App Div.1987).

<sup>15</sup> *Lamden v La Jolla Shores Clubdominium Association*, 980 P. 2d. 940 (Cal. 1999). In another "pest eradication" case, an Ohio appellate court refused to engage in the "de novo" review of a board's decision to access a unit to exterminate cockroaches where doing so was permitted by the Association's governing documents. *River Terrace Condominium Association*, 514 N.E. 2d 732 (Ohio App. 1986).

<sup>16</sup> Also see *Agassiz West Condominium Association v Solum*, 527 N.W. 2d 244 (N.D. 1995) (adopting the business judgment rule but not prohibiting an owner for suing for violation of the bylaws).

<sup>17</sup> *Levandusky v One Fifth Avenue Apartment Corp.*, 553 N.E. 2d 1317 (N.Y. App. Div. 1990).

and experience peculiarly qualify them for the discharge of that responsibility.”<sup>18</sup> These capabilities and experience relate, in part, to an awareness of the sensitivities and politics of a community that would be undermined if subject to judicial interference.<sup>19</sup>

Courts may also be disinclined to inject themselves into a board’s daily business operation where no abuse is shown. For example, in *Ostayan v Nordhoff Townhomes Homeowners Association*,<sup>20</sup> the association was sued for breach of fiduciary duty for failing to timely disclose the filing of suit against its earthquake insurer which had improperly denied policy benefits (though notice of the dispute had been well documented). Plaintiff argued there was such a duty and sued for his share of the recovery distributed to members after his property was sold. In noting that neither the association’s governing documents nor California’s comprehensive statutory disclosure scheme required specific disclosure of this type of lawsuit, the court, citing business judgment cases and denying the claim, held, that “whether and when” to give notice was within the discretion of the board.<sup>21</sup>

Another recent “operations” case, *40 West 67<sup>th</sup> Street Corporation v Pullman*,<sup>22</sup> applied the business judgment rationale to sustain eviction of an unruly housing cooperative member. The governing documents permitted eviction if approved by a supermajority membership vote. Approval was obtained following a meeting, written notice of which was sent all members, including the member the target of the eviction. New York’s highest court did not particularly evaluate whether there was a substantial basis for the eviction per se but rather focused on the fact that the association (“unfailingly”) complied with governing document due process requirements, authorized action that was consistent with legitimate corporate purposes and was not shown to have acted in bad faith or with improper “favoritism.” *Pullman* also neatly shows that even though the tenant had harassed the Association’s president, the decision to litigate the eviction was not motivated by improper bias or “interest.”<sup>23</sup>

In the deference cases, the focus is not on whether the board’s decision – to be more or less aggressive in dealing with building needs, when to disclose information, to keep assessments at a certain level<sup>24</sup> - is right or wrong, smart or stupid; instead the issue is whether the decision or conduct was shown by the complaining party to have been *ultra vires*, made in bad faith or not intended to serve the community’s interest. By contrast and in theory, at least, as suggested by the Restatement Reporter’s observation, other cases apply the more rigorous “reasonableness” test which requires the association to demonstrate a nexus between its conduct or rule and the association’s purposes and board authority.<sup>25</sup> A good example occurred in a Texas case where, upon an owner’s refusal to pay the special assessment to

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<sup>18</sup> *Levandusky, supra*, 553 N.E. 2d at 1322 (citation omitted).

<sup>19</sup> *Id.*; also see *Lamden*, 980 P. 2d at 942 (deference is proper given the “relative competence, over that of courts, possessed by owners and directors of common interest developments to make the detailed and peculiar economic decisions necessary in the maintenance of those developments.”).

<sup>20</sup> *Ostayan v Nordhoff Townhomes Homeowners Association* (2003) 110 Cal. App 4<sup>th</sup> 120.

<sup>21</sup> *Ostayan, supra*, 110 Cal. App 4<sup>th</sup> at 129. The Association had, while plaintiff still was a member, distributed to all members three letters describing the insurer’s refusal to pay policy benefits and the board’s determination to “take further legal action” should it be necessary.

<sup>22</sup> *40 West 67<sup>th</sup> Street Corporation v Pullman*, 790 N.E. 2d 1174 (N.Y. 2003); reported in the August 2003 Community Association Law Reporter.

<sup>23</sup> The member claimed his upstairs neighbor and the President’s wife were having an affair; the member had commenced four lawsuits against the President and the Association’s management and had tried to file another 3 more. It belies logic to say the President was not “interested” in the outcome; the point however is that propriety of the eviction stood on its own and was not shown to have been motivated by specific, personal relations between the President and the evictee.

<sup>24</sup> *Goddard v Golden Fairways Dev. Gen Partnership* 426 S.E. 2d 828 (S.C. App. 1993)

<sup>25</sup> *Hidden Harbor Estates v Norman*, 209 So. 2d 180 (Fla. App 1975) (rule prohibiting alcohol in common area was reasonable and not arbitrary); *Ryan v Baptiste*, 565 S.W. 2d 196 (Mo. App. 1978) (installation of door locks deemed reasonable).

finance repair to gas lines, the appellate court sustained the assessment not just because the board acted in good faith to protect the project but because it “reasonably believed” its actions were necessary and since there was “no evidence to suggest that the Association acted unreasonably” and where its duties included protection of the buildings in the development.”<sup>26</sup>

Unrecorded rules adopted after the covenants were first recorded are not entitled to the same deference as the original covenants;<sup>27</sup> also, when broad discretion vests in a committee (with, for example the power to approve or disprove plans based on "harmony of external design, location and relation to surrounding structures and topography") it cannot be exercised arbitrarily (to deny an owner's plans where the community aesthetic is a “cacophony” of house styles)<sup>28</sup> or where others have been treated differently (where permitted homes have a similar look to the one prohibited).<sup>29</sup> And, whether or not business judgment deference is applied liberally or not at all, courts will punish improper board conduct.<sup>30</sup> Thus in *Franklin Valley Chateau Blanc Homeowners Association v Department of Veterans Affairs*,<sup>31</sup> an elderly member with Hotchkins disease was permitted to pursue a cross complaint for damages arising out of a board's unreasonable suit seeking relief for the possession of too many books and papers which the board claimed was a nuisance and (without expert support) a fire hazard.

## V. Good Faith and Due Process

The willingness to avoid “second guessing” board decisions, the point of business judgment defense principles, is based on the (rebuttable) presumption that directors' actions are made in good faith, authorized by corporate documents and reflect the experience or expertise of the directors.<sup>32</sup> To take advantage of the defenses, directors must actually “act.” “The business judgment rule may apply to a deliberate decision not to act, but it has no bearing on a claim that directors' inaction was the result of ignorance.”<sup>33</sup>

The “action” taken must be made in “good faith” and not for the purpose of providing a director a direct benefit (though it is obvious that, as owners, directors will frequently be affected board decisions). Directors must, prior to making decisions, acquire and evaluate relevant data, including input from experts. This obligation is particularly apt in the community association environment where board service requires no expertise and typically the only qualifications are that a person volunteers, is an owner of record and has timely paid their assessments.

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<sup>26</sup> *San Antonio Villa Del Sol Homeowners Association v Miller* 761 S.W. 2d 460 (Tex. App 1988).

<sup>27</sup> *Hidden Harbour Estates v. Basso* 393 So.2d 637, 640 (Fla.App. 1981); see *Apple II Condominium Association v Worth Bank & Trust. Co.* 659 N.E. 2d 93 (Ill. App 1995) (affirming application of lease restrictions contained in amended covenant to pre-existing owners but noting a higher reasonableness standard applicable to board rules).

<sup>28</sup> *Town & Country Estates Association v. Slater* 740 P.2d 668, 669 (Mont. 1987).

<sup>29</sup> *Ashelford v. Baltrusaitis* 600 S.W.2d 581, 588 (Mo. App. 1980).

<sup>30</sup> *40 West 67<sup>th</sup> Street v Pullman, supra*, 790 N.E. 2d 1174, 1180-1181 (“[D]espite this deferential standard, there are instances when courts should undertake a review of board decisions).

<sup>31</sup> *Franklin Valley Chateau Blanc Homeowners Association v Department of Veterans Affairs* (1998) 67 Cal. App 4<sup>th</sup> 743.

<sup>32</sup> *Levandusky, supra*, 553 N.E. 2d 1317; *Papalexioiu v Tower W. Condominiums*, 410 A. 2d 260, 286 (N.J. Super. Ct. Ch. Div. 1979) *Lamden, supra*, 980 P. 2d at 942.

<sup>33</sup> *Rabkin, etc. v Hunt* 547 A. 2d 963, 972-973 (Del. Court of Chancery 1986) (business judgment rule does not protect directors' failure to learn about the terms of a stock purchase agreement which may have resulted in economic loss to minority shareholders).

While the business judgment rule lends no protection to conduct deliberately singling out for disparate treatment an owner,<sup>34</sup> or a class of owners,<sup>35</sup> or arbitrary action,<sup>36</sup> the typical inquiry is more about whether directors' decisions are intended to serve goals consistent with the Association's purposes and are not shown to reflect bad faith, arbitrariness, favoritism, discrimination or malice.<sup>37</sup>

The "good faith" aspect of a director's obligation also consists of assuring procedural fairness in the decision making process which includes abiding by the bylaws or covenants. Thus, a Montana association was denied summary judgment in *Edgewater Townhouse Homeowners Association v Holtman* where the board could not, in a suit to collect an unpaid \$3,900 special assessment to finance installation of a new heating system where the board could not demonstrate the membership approval required by the documents.<sup>38</sup> Even where the violation is obvious and undisputed, as in the case of an owner's failure to submit architectural plans prior to a lot alteration, summary judgment can be denied where the board cannot demonstrate compliance with its own governing documents.<sup>39</sup> "Hearings," or at least the opportunity to be heard, must (though generally not in connection with delinquent assessments) be afforded prior to the imposition of sanctions by the body authorized to dispense discipline, whether it be the board<sup>40</sup> or the association.<sup>41</sup> On the other hand, where the declaration fails to vest in the association the authority to take a particular action, such as the denial of a building application unsupported by narrowly drawn architectural covenants, no amount of "due process" will transform the action to make it lawful.<sup>42</sup>

## VI. Covenant Disputes

Where state statutes vest in recorded covenants a presumption of reasonableness, they will be given a deference similar to what is found in the business judgment cases. In Florida, where a statutory scheme permits broad authority for amending a condominium declaration, an amendment restricting leasing rights applicable to members whose ownership pre-existed the amendments was upheld by the Supreme Court which rejected the trial court's characterization of the amendment as an unreasonable restraint on alienation.<sup>43</sup> Likewise, California's Supreme Court held that a use restriction (an absolute pet ban) was presumed valid unless the objecting owner could demonstrate that it violated public policy or, as applied to the entire development, was unreasonable.<sup>44</sup> These cases, however, did not involve

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<sup>34</sup> *Smukler v 12 Lofts Realty, Inc.* 546 N.Y.S. 2d 862, 863 (App. Div. 1993); this case has a vituperative history; see *Smukler v 12 Lofts Realty, Inc.* 528 N.Y.S. 2d 437 (App. Div. 1989) (permitting tortious interference claims arising out of board's alleged refusal to permit sale unless seller agreed to expand use of roof to other association members).

<sup>35</sup> *Country Square Condominium Association v Halpern* 436 A. 2d 580 (N. J. Super 1981) (holding unreasonable a board adopted rule charging rental fees only to non resident owners).

<sup>36</sup> *In Re Croton River Club* 52 F3d 41 (2 Cir. 1995) (refusing to invoke rule to permit unfair, arbitrary allocation of special assessment).

<sup>37</sup> *40 West 67<sup>th</sup> Street Corporation v Pullman, supra*, 790 N. E. 2d 1174, 1181-1182.

<sup>38</sup> *Edgewater Townhouse Homeowners Association v Holtman* 845 P.2d 1224 (Mont. 1993).

<sup>39</sup> *Ironwood Owners Association IX v Solomon* (1978) 178 Cal. App 3d 766, 772 ("When a homeowners association seeks to enforce the provisions of its CC&Rs 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").

<sup>40</sup> California Civil Code Section 1363(h); UCIOA Section 3-116.

<sup>41</sup> *40 West 67<sup>th</sup> Street Corporation, supra*, 790 N. E. 2d 1174 (sustaining, on business judgment grounds, eviction of a "nuisance" approved by the members at a duly noticed membership meeting).

<sup>42</sup> *Riss v Angel*, 912 P.2d. 1028, 1034 (Ct. App. Wash 1996) (in rejecting architectural application, unincorporated association acted outside its authority).

<sup>43</sup> *Woodside Village Condominium Association Inc. v Jahren* 860 So. 2d 452 (Fl. 2002).

<sup>44</sup> *Nahrstedt v lakeside Village Condominium Association* 878 P. 2d 1275 (Cal. 1994).

interpretation but rather implementation of recorded CC&Rs the meaning of which was not disputed. Thus, “deference” to the board’s “business judgment”, in contrast to that shown a clearly written recorded covenant, was not at issue.

On the other hand, where the issue does involve the meaning of a CC&R provision, courts are less likely to defer to the board’s expertise since nothing about it particularly trains directors for the task. Instead, fleshing out the meaning of a CC&R restriction, like divining the meaning of a contract or administrative regulation, is an exercise familiar to judges and one for which they are trained. Additionally, the meaning of CC&Rs, whether characterized as “contracts” or “deed restrictions” is subject to common law standards based on the statutes and cases of a particular jurisdiction and generally not the circumstances of a specific community, board or individual. Likewise, while business decisions concern how corporate-like tasks are performed, CC&R enforcement deals with the touchier and perhaps deeper subject of private property regulation. These are some of the reasons why a board’s interpretation of CC&Rs, whether directly or indirectly resting on a business judgment rationale, may not generally be deferred to by a trial or appellate court.

In *Riss v Angel*,<sup>45</sup> for example, the board of an unincorporated Washington state association refused to permit construction of a home whose height was lower than the maximum permitted by the CC&Rs, larger than the minimum square footage required and consistent with set back prohibitions. The CC&Rs contained no other objective criteria though the association had the generic authority to deny architectural applications for any, including, aesthetic reasons. Whether the application met the requirements of the CC&Rs was, in the court’s opinion, a question of judicial interpretation and not subject to deference to board discretion.

An Oregon board’s determination about the meaning of CC&R architectural provisions was also rejected in *Littlewhale Cove Homeowners Association v Harmon*.<sup>46</sup> The board claimed the CC&Rs required the owner to submit an architectural request to the association before applying to the City for a needed variance; when the owner first applied to the City, the board levied a fine of \$11,025 and recorded a lien against the owner’s property to secure payment. On the owner’s challenge, the court sidestepped the deference question by noting that the CC&Rs vested architectural authority in the architectural committee and not the board; since the board violated the CC&Rs by making the decision instead of the committee, the court deemed deference inappropriate. Then, itself construing the CC&Rs, the court concluded the timing requirements of the CC&Rs did not compel owners to make initial architectural submissions to the association.

On the other hand, where architectural “aesthetic” controls are at issue, the “internal” determination of an association is likely to be affirmed. Thus, one Arizona court found (albeit without reference to deference or the exercise of business judgment) that a CC&R provision prohibiting a “trailer, camper, boat or similar equipment” could be read to include “customized bus” even though Arizona covenants are strictly construed to be subordinate to the “free use and enjoyment” of property.<sup>47</sup> Another case permitted enforcement of a ban on vinyl siding where the owner failed to show that the architectural committee acted in bad faith or unreasonably.<sup>48</sup> In a case involving fences and windows, a California appellate court, discussing different relevant review standards sustained aesthetic conclusions reached by

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<sup>45</sup> *Riss v Angel*, 934 P. 2d 669 (Wash. 1997).

<sup>46</sup> *Littlewhale Cove Homeowners Association v Harmon*, 986 P. 2d 616 (Or. App 1999).

<sup>47</sup> *Arizona Biltmore Estates Association v Tezak* 868 P. 2d 1030, 1032 citations omitted (Ariz. App. 1993).

<sup>48</sup> *Raintree Homeowners Association v Bleima*, 463 S.E. 2d 72 (N.C. 1995).

the “art jury” not based on “business deference” but because the committee had the power to decide and was not shown by the disappointed applicant to have acted unreasonably or arbitrarily.<sup>49</sup>

In *Johnson v The Pointe Community Association, Inc.*<sup>50</sup> an Arizona appellate court found wrongful a board’s failure to require an owner to comply with the CC&Rs pre-approval requirements applicable to an exterior building modification. The court distinguished *Lamden* and *Levandusky*, saying deference was not required in a CC&R interpretation case and that neither decision barred owner challenges where board action was without consideration of the relevant facts or beyond the scope of board authority. These distinctions are not (in my view) particularly persuasive and the case illustrates that “bad facts” can make bad law:” the record failed to reveal why the board refused to require an architectural application or whether it considered any series of graduated enforcement steps intended to lead toward compliance with the CC&R requirements. .

Where a board refuses, without reason, to enforce an affirmative covenant, courts will intervene as in *The Pointe* and another Arizona case, *Gfeller v Scottsdale Vista North*.<sup>51</sup> There, the board refused to enforce a CC&R prohibition against improper drainage affecting a neighbor’s lot; the court conducted a “de novo” review of the board’s responsibilities and concluded that the CC&R provision stating that the board had the “right and duty” to enforce required it to do so. On the other hand, in *Beehan v Lido Isle Association*<sup>52</sup> on business judgment grounds, a California appellate court refused to penalize an association that failed to enforce a recorded construction set-back provision where the record showed the board evaluated the difficulty, expense and benefits of enforcement and then refused to pursue the violation.

## VII. Advising Community Association Clients

The holding and rationale arising out of challenges to association authority vary depending on jurisdiction, relevant statutory language, idiosyncratic fact patterns and in some cases whether the dispute focuses on the original declaration or amendments or board adopted “house rules.” Still, it is possible to distill from the cases concerns which, properly addressed, can significantly enhance the likelihood that board association conduct will withstand scrutiny. In no particular order, these include:

### 1. Compliance With Voting Rules

It is imperative that timing and content rules concerning notices and ballots dealing with adoption of a member approved CC&R amendment or a “house rule” by the board<sup>53</sup> comport with relevant statutes and governing document requirements.

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<sup>49</sup> *Dolan-King v Rancho Santa Fe Association* (2000) 81 Cal. App 4<sup>th</sup> 965).

<sup>50</sup> *Johnson v The Pointe Community Association, Inc* 73 P.3d 616 (Ariz. App. 2003).

<sup>51</sup> *Gfeller v Scottsdale Vista North* 969 P2d 658, 660 (Ariz. App 1998).

<sup>52</sup> *Beehan v Lido Isle Association* (1978) 70 Cal. App 3d 858 The court said “For purposes of this decision we shall assume Association was obligated in appropriate circumstances to take action to enforce the declaration of restrictions” and accepted that the case at issue was not one of those “appropriate circumstances.” 72 Cal. App 3d at 865.

<sup>53</sup> California Civil Code Sections 1357.100, et seq., effective January 1, 2004, require notice to members before the board can adopt a rule and by majority vote allows members to “reverse” rule changes proposed to be adopted by the board.

## **2. *Compliance With and Knowledge of Governing Documents***

Whether relating to voting, notices, enforcement procedures, or substantive requirements, it is essential that the association follow its own governing documents. Directors should generally be aware of key governing document provisions. In particular, boards should be sure adequate books and records are kept and that mandated financial disclosures are adequately and timely made.

## **3. *Due Process***

Relevant timing requirements must be met prior to imposition of discipline (fines, suspension of other membership rights) or the rejection of architectural applications. Further, the nature of the disciplinary charges or the bases of the use restriction or architectural objections should be identified in a manner that tracks the requirements of the bylaws, CC&Rs or rules. For example, where the CC&Rs allow a building modification unless the design review committee finds the proposal will not be consistent with “community standards” and “aesthetics,” a rejection should identify those standards and set forth why the application failed to comply or was inconsistent with the “look” of the community. Likewise, where a board intends to impose discipline, the hearing notice should cite the factual basis of (and documents supporting) the claim as should the resolution concluding discipline was warranted.

## **4. *Inquiry, Investigation and Participation***

The “informed” director is one which asks questions – of management, counsel, architects or other experts—before concluding how to spend money, enforce CC&Rs, make repairs, etc. Many times, alternative courses of conduct will present themselves; boards should consider alternatives taking into account answers to questions received, budgetary issues, political considerations and other factors. Arbitrary decision making is not likely to withstand challenge. It is also worth stating the obvious: directors should attend meetings and evaluate and review minutes, management and expert reports and bids prior to decision making.

## **5. *Vet Issues; Consider Amendments***

Enlisting members in the decision making process by keeping them reasonably informed and providing an outlet for contemplated courses of action is a prudent method of blunting criticism, thereby reducing the risk of challenge and the possible claim a board has not acted “in good faith.” Where membership input suggests alternative approaches, or where the solution to a problem might be an amendment expanding or diminishing the power of the board or the association, these options should be given proper attention. “Giving proper attention” to member concerns is not the same, of course, as saying a board should always defer to member view points but only that these should be acknowledged and considered.

## **6. *Experts***

Since directors may not have relevant training or expertise, they can and should rely on the advice of experts. The advice does not necessarily have to be followed but whether it is or is not, the basis for whatever action is taken on expert advice should be clearly spelled out. Where experts “warn” the board of the physical, fiscal or potential consequences of one course of action or another, these warnings should be carefully evaluated.

## **7. *Confidential Communications***

Where boards rely on the advice of counsel or other experts to support their business judgment, that advice can sometimes be disgorged in discovery. Even the “executive session” cloak may be ineffective to shield otherwise privileged communications where those communications form the basis of a business judgment defense. Counsel and clients should both be aware of the possibility discovery may lead to the disclosure of such communications and early on address the issue in a manner calculated to protect the association’s interests.

## **8. *Loyalty/Conflicts/Good Faith/Abiding By The Governing Documents***

Directors must be loyal, avoid conflicts of interest and act in good faith. Decisions, especially those which are financial, must support the association’s purposes and goals and promote the interests of the members. Conflicts of interest, even where permitted by law upon proper notice and approval, are generally unwise; where necessary, they should be of limited duration. Directors should, themselves, be mindful of the requirements of their office and their status as owners and should endeavor to comply with both.

## **9. *Written Policies***

Where possible, boards should act pursuant to lawful written policies that are consistent with the scope of power vested in the board by statute and the association’s governing documents. Policies should be crafted to reflect the source of power and the manner in which the policies serve the association’s interests.

## **10. *Look Ahead***

Before embarking on a path that may predictably culminate in litigation, counsel and client should project how board conduct will be viewed by objective observers at some point in the future. Few directors are used to the scrutiny that accompanies litigation and this simple “looking glass” test can prevent or minimize significant problems before they arise.

## **11. *Document Properly***

Volunteer directors and paid managers “come and go” and those on the board, when a decision is made, may not be available when challenges result. Proper documentation (not just casual electronic mail communications) can enhance a board’s “business credibility” and the potential success of a claim or defense. Properly adopted, signed minutes revealing quorums, decisions and their bases; documentation showing the basis for the exercise of board or committee discretion; paper trails clearly revealing how an issue and the board’s response to it evolved; writings presenting the context--political, practical, economic or otherwise--in which decisions are made; notices of meetings with agendas; newsletters reporting the consequences of board actions or tentative decisions; architectural applications properly executed by committee or board members as required by the governing documents; and other types of documentation all serve the purpose of helping support and defend board and community decision and action.

## **VIII. A Peek Into The Future**

It is likely the next few years will witness more cases and statutes dealing with standards of review of board and community association conduct. We have seen an explosion of law review articles dealing with these standards and a few high profile cases that have not met with universal approval. Further, legislators seem inclined to enact laws based on apocryphal complaints about board behavior driven by websites and email trees authored by those who may be uninformed, or worse, whose interests may be incompatible with a “common interest” of association members. The evolution of “business judgment” rule and deference cases will necessarily be affected by these developments and so bear watching and analyzing in the years to come.

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