Board of Directors' Guide

Fiduciary Duty

January 1994

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NOTE TO THE READER

The "author-date" references for source citation in combination with endnotes have been utilized in this publication. The "author-date" form consists of the author's last name, year of publication of the work and specific page, section or other element of the cited work (eg., Jones 1999, 125). "Author" means the name under which the work is alphabetized in the Bibliography (p 24). Endnotes have been used to permit lengthy documentation and amplified explanations required by the nature of the materials presented in this booklet. Source consulted: *The Chicago Manual of Style,* 14th ed. 1993, (The University of Chicago Press, Chicago, Illinois).

The "legal citations" form consists of the name of the case, the volume number of the Reporter where the case can be found, the Reporter name, and series number, page number, the court and date of the decision.

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Section 514A-82.4, HRS (Condominium Property Regimes, Chapter 514A, HRS), specifies that each director owes a fiduciary duty to the association of apartment owners. This fiduciary duty governs the director's performance of his or her responsibilities.

Fiduciary duty is a legal principle and may also be viewed as a bundling of a number of obligations. These obligations include the duty of:

- obedience
- diligence (due care)
- loyalty
- good faith

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Board members are required to manage the affairs of the association in accordance with the Condominium Property Regimes, Chapter 514A, HRS and Title 16, Chapter 107, HAR, declaration, bylaws, house rules, association policies and other applicable laws.

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Abbreviations

§	**Section**
HRS	**Hawaii Revised Statutes**
HAR	**Hawaii Administrative Rules**

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In general, where a conflict of interest exists, the condominium statute in Hawaii requires a director to:
1) abstain from voting on any issue before the board (§514A-82(a)(13), HRS); and
2) disclose the nature of the conflict prior to a vote and ask that the minutes reflect that a disclosure has been made (§514A-82(b)(5), HRS).

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- Acting in good faith for an association purpose (not in self-interest);
- Acting with such care as an ordinary reasonable prudent person in a like position would under similar circumstances; and
- Acting in manner believed to be the best interest of the association.

At times in carrying out the big job, a member may make an honest mistake. Thus, when the mistake is indeed an honest mistake the courts generally do not hold the board member personally liable.

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The [fiduciary] duty to act in good faith and with diligence, care, and skill [obedience, undivided loyalty] does not apply only to the "business" decisions and activities of the association. This duty also applies to the governmental or regulatory decisions that the board of directors must make.

Chapter 514A, HRS, imposes on board members a number of responsibilities for managing the affairs of the association. Other responsibilities, not prohibited by Chapter 514A, HRS, may also be imposed on board members by the condominium declaration, bylaws, house rules and in some cases by court decisions.

A board member's fiduciary duty in carrying out any responsibility includes at minimum following those procedures specified in the statute, declaration, bylaw, or rule.

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Basically, each director owes the association of apartment owners a fiduciary duty in the performance of the following responsibilities (a non-exhaustive listing): 14

- Maintaining, repairing and replacing association property including the negotiating and executing of contracts for such (§514A-83.6, HRS);
- Giving of, at least 30 days, prior written notice of any maintenance fee increase (§514A-92.2, HRS);
- Exercising the board's right to change the use of or lease common elements, with proper approvals (§514A-13(d), HRS);
- Opting to authorize the installation of separate metering for utilities with restrictions (§514A-15.5 (b) HRS);
- Conducting board elections (§§514A-82(a)(1),(15),(16),(17) (b)(3), HRS) and using proxies (§514A-82(b)(4), HRS);
- Disclosing conflicts of interests (§§514A-82(a)(13) and (b)(5), HRS);
- Managing the association's fiscal affairs including:
  - adopting and distributing an annual budget (§514A-83.6, HRS),
  - conducting and funding a reserve study, maintaining an adequate reserve fund (§514A-83.6, HRS),
  - assessing unit owners (§514A-15, HRS) (including enforcing collection of assessments),
  - disbursing assessments; depositing and investing association funds (§514A-97(c), HRS),
  - electing to borrow money for the repair, replacement, etc. of the common elements with 50 percent owner approval (§514A-82.3, HRS);
- Keeping association funds safe, including the prohibition of transferring funds between accounts by telephone (§§514A-15 & 514A-97(d), HRS);
- Maintaining and making available to owners:
  - books and financial records (§§514A-83.5 and 514A-85, HRS),
  - association and board minutes (§§514A-83.4 and 514A-83.1, HRS),
  - membership lists (§514A-83.3, HRS),
  - proxies and other related election records (§514A-83.5, HRS),
  - summary of insurance information (§514A-86, HRS),
  - a copy of the association's annual audit, a summary of it, or if the audit has not been completed at the time of the request, a current financial statement for the association (§514A -96(b), HRS) available to the unit owners with restrictions (§§514A-83.4, and 514A-83.5, HRS);
- Amending governing documents in accordance with statutory requirements including the required percentage of votes (§§514A-81, 514A-82(b)(2), and 514A-82.2 HRS);
- Adopting and amending administrative rules for the operation of the association and use of the common elements (§514A-82(a)(9), HRS);
- Enforcing covenants, bylaws, and administrative provisions (§§514A-88 and 514A-82(a)(18) HRS);
- Reviewing requests for approvals for additions and alterations to be

made within the limited common elements or within an apartment (§§514A-13 and 514A-15, HRS);

- Scheduling and conducting association and board meetings (§§514A-83.1 and 514A-82 (a)(15), (16), (17), HRS);
- Protecting condominium owners and property including:
  - providing for emergency entrance and repairs and other repairs for the operation of the project (§§514A-82 (b)(6), and 514A-13(f), HRS);
  - bringing where appropriate and settling suits in such matters including but not limited to the common elements, the roof and structural components of a building, mechanical, electrical and plumbing elements;
  - conducting background checks of employees such as security guards or managers or other positions which would allow the employee access to keys or entry into units (§§514A-82.1 and 846-41, HRS);
  - purchasing and maintaining a policy of fire insurance to cover the common elements and all exterior and interior walls, floors, and ceilings of the condominium project (flood insurance if the project is located in a flood hazard area (§514A-86, HRS);
  - fidelity bonding for those specified individuals who handle the funds of the association (§514A-95.1, HRS);
  - conducting an annual audit and one annual "unannounced" verification of the association's cash balance by a public accountant (§514A-96, HRS);
- Complying with provisions for resignation and removal of directors where appropriate (§514A-82(b)(1), HRS);
- Deciding whether to hire a managing agent (§514A-95, HRS);
- Registering annually, the association of apartment owners with the Real Estate Commission and obtaining a fidelity bond (§514A-95.1, HRS).

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Boards may delegate some of their duties to officers, employees, and managing agents. Officers and managing agents are agents of the association. As agents, they owe a fiduciary duty, just as do board members to the association.

Although a board can delegate its duties it cannot avoid responsibility for carrying out its duties or for the non-performance of those duties.

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To encourage condominium owners to serve on boards without excessive fear of personal liability, the condominium governing documents should provide that the association be responsible for the reimbursement (indemnification) of certain losses, and expenses including costs and reasonable attorneys fees, incurred by a board member in defending him or her self for

their good faith decisions made while serving on the board.

An indemnification provision by the association itself may be considered inadequate protection. The association may not have the funds to indemnify the director and officer when the need arises. Thus, governing documents providing for indemnification and requiring the association to obtain directors' and officers' liability insurance appears to be the better vehicle for providing protection for board member liability.

Associations with governing documents providing for indemnification of board members, but are unable to obtain directors' and officers' insurance coverage, must investigate other funding sources e.g., self-insurance, surety bonds, guarantees by other agencies, etc.

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1. Serve one principal—the association.

2. Make decisions for one mission: the health, happiness, and welfare of the condominium association including the preservation of the condominium common elements.

3. Rise above self-interest.

4. Make decisions based on information, research, professional consultation where required; in arriving at a decision, act independently and not at the direction and dominance of another board member.

5. Act prudently in making decisions, do what the "Reasonable Person would suggest and do under like circumstances."

6. Be knowledgeable of the affairs of the association, this includes:
   - having a working knowledge of the association's minutes, policies, and governing documents - declaration, bylaws, house rules, condominium laws - Chapter 514A, HRS, and other related administrative rules, decisions and policies of the Real Estate Commission.

7. Be responsive to the residents you serve–this may include:
   - surveying the residents' opinions on appropriate issues.

8. Consult experts when you are unfamiliar with the issues; i.e., attorneys specializing in condominium governance and administration, accountants, reserve specialists, contractors, plumbers, electricians, etc.

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9. Consult more than one expert to insure that you have gathered information on which to base your decision; but remember that intentionally shopping around for a pre-selected biased opinion may not be deemed reasonable.

10. Attend courses and other seminars relating to managing the affairs of the association.

11. Keep abreast and be aware of court decisions, legislation, new federal and state laws, and county ordinances.

12. Hire managing agents and resident agents after a thorough investigation including applicable license history, reputation in the community, and reasonable price for rendered professional services (seek more than one bid for any job).

13. Amend declaration and bylaws, if necessary, to include provisions that the association be responsible for costs and reasonable attorney's fees incurred in defending oneself as a board member for the good faith decisions made while serving (association may provide for this by indemnification and directors' and officers' insurance);

14. Give clear directions to the association's officers, employees, and agents as to the scope and limitations of their duties and responsibilities;

15. Review the performance of the association's agents and implement procedures to prevent activities beyond the scope and authority of the duties delegated.

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Introduction

This booklet specifically provides:

- guidance as to the conduct expected of board members in the areas of:
  - the business affairs of the association;
  - rule making and enforcement;
  - administrative affairs of the association;
  - supervision of the association's agents;
- suggestions for minimizing or eliminating a board member's exposure to personal liability for actions taken while on a board; and
- suggestions for providing protection for board members against potential personal liability for actions taken while on the board.

The information discussed in this booklet has been collected from the literature on the subject, law review articles, the reported cases of Hawaii's courts, state and federal courts, and discussions with local board members and condominium managing agents. This booklet is a sequel to the publication, *Condominium Board Members Powers and Duties,* published September 1991, by the Hawaii Real Estate Commission. That publication informed board members about the specific standards of conduct mandated by Chapter 514A, Hawaii Revised Statutes (HRS) which each member must follow.

Appearing in the beginning of this booklet is a "Quick Reference" to many of the issues discussed in this booklet. The "Quick Reference" serves both as an outline summary of the important issues and suggestions discussed in this booklet and as a table of contents. However, the full benefit of the information provided will be obtained by a complete reading of the booklet.

Limitations of the Provided Information. This booklet is not intended to give legal advice nor to substitute for such. Readers having specific questions about the information provided and its applicability to a particular circumstance should seek the professional services of an attorney or other qualified professional experienced with advising condominium board of directors.

The editors, publishers, and contributors to this booklet cannot and do not render an opinion about how Hawaii courts will decide a claim that a board member has failed to comply with any of the expected conduct discussed in this booklet. Court decisions are made on a case-by-case basis on very specific factual circumstances.

Many condominium associations in Hawaii are unincorporated. Other states such as California and Florida have a developed body of case law specifically applicable to condominium associations and board conduct; Hawaii apparently has not.

In providing guidance as to what the body of expected conduct is for a board member of a Hawaii condominium association, the editors, publishers, and contributors will discuss, **for educational purposes only**, a spectrum of related court decisions and literature.[1] It should be noted that the cases discussed here sometimes involve a for-profit corporation, a non-profit corporation or an unincorporated association.[2]

Associations which are incorporated as business corporations and those which are incorporated as non-profit corporations are also subject to Chapters 415 and 415B, Hawaii Revised Statutes, and other applicable state and federal laws.

On Becoming A Director

Not all associations conduct a swearing-in ceremony for association directors. However, the vision of such helps to impart the importance of the office and the meaning of the fiduciary duty a director assumes on taking office.

Although, fiduciary duty has been explained in many ways, it may be simply understood by considering an oath that directors might take upon assuming office. This oath [3] may look something like this:

I, *(state your name)*, promise:

- to do my best to manage the affairs of this association;
- to faithfully and carefully execute my duty to the association of apartment owners;
- to promote above all else the general welfare of the association; and
- to abide by, in managing the affairs of the association, the mandates of the condominium statute, rules, declaration, bylaws, house rules, the laws of this State and County, and the laws of the United States.

Endeavoring to adhere and remain faithful to these implied promises helps board members fulfill the fiduciary duty each owes to the association. An expanded discussion of each of these promises and the apparent related legal principle appears throughout this booklet.

What Do Board Members Do?

"Whether the association is incorporated or unincorporated, the basic nature of the duties of the individuals responsible for operating the association are the same. . . . They are volunteers with a big job. . . ." (Hyatt 1989, 65).

The "big job" was previously described in the Real Estate Commission's publication, *Condominium Board Members Powers and Duties,*:

"The board of directors has broad authority to manage the affairs of the condominium association. The board governs the association, establishes polices and rules, ensures the accuracy of financial and administrative records, maintains the common elements and promotes a quality environment for all residents. . . ." (HREC 1991, 29).

Because of the critical role the board plays in the life of the association, board members need to be aware of their responsibilities and be familiar with the law and the condominium documents. It is equally important that association board members be aware of what courts have held and what the literature has discussed as expected conduct for board members.

For condominium owners who are directors and for owners contemplating becoming a director, fear of personal liability for board decisions is not unfounded. However, some courts have articulated a number of processes and procedures which may protect board members from such liability. These processes and procedures will be discussed in the sections to follow.

One author observed that courts defer to board decisions and actions because:

- courts wish to ensure that effective and efficient management is encouraged (requires that board members have the freedom to make management decisions without excessive fear of liability);
- board members have expertise for their discretionary decisions; and
- courts recognize the difficulty of after-the-fact re-evaluation (Di Lorenzo 1990, 4).

Basic Conduct Expected of Board Members

Generally, roles are connected to a set of conduct or behavior. Board members are described by statute as fiduciaries. In this section, the basic conduct expected of board members as fiduciaries is discussed separately. Inherent in these basic expected conduct are a number of promises. These promises are also discussed throughout this booklet.

These fiduciary promises include a board member pledging:

- To do his/her best to manage the affairs of the association;
- To faithfully and carefully execute his/her fiduciary duty to the association of apartment owners;
- To promote above all else, the general welfare of the association; and
- To abide, in managing the affairs of the association, the mandates of the condominium property regime statutes, rules, declaration, bylaws, house rules, the laws of the United States, this State and County.

The Fiduciary Duty — The Promises: To Do One's Best, To Faithfully and Carefully Execute One's Duty

Section 514A-82.4, Hawaii Revised Statutes, specifies that each director owes a fiduciary duty to the association of apartment owners. This fiduciary duty governs the director's performance of his or her responsibilities. This fiduciary duty was previously defined in the publication, *Condominium Board Members Powers and Duties* and is repeated here:

> *"A fiduciary relationship is a special type of relationship which arises when the confidence, trust, and reliance of one party is placed upon the judgment and advice of another. A fiduciary is bound to protect the interests of the parties relying on them. . ." (HREC 1991, 16)*

As fiduciaries, directors have a duty to act in good faith and to place the interest of the apartment owners above their own interest at all times. Officers and directors are held to this high standard of conduct, the breach of which may subject each or all of them to personal liability, even if they are acting on behalf of the association. The fact that the officers or directors are part-time volunteers does not excuse them from their fiduciary duty.

On this subject, authors Hyatt and Rhoads, note:

> *"The business and governmental aspects of the association and the association's relationship to its members clearly give rise to a special sense of responsibility upon the officers and directors whether they be a developer, the developer's agents, or individual unit owner volunteers. The special responsibility is manifested in the requirements of fiduciary duties and the requirements of due process, equal protection and fair dealing. . . .(Hyatt and Rhoads 1976)."*

Fiduciary duty is a legal principle and may also be viewed as a bundle of obligations. These obligations include the duty of:

- **Obedience**
- **Diligence (due care)**
- **Loyalty**
- **Good Faith**

Each director is expected to exercise this bundle of obligations in managing the affairs of the association. Some experts call these bundled obligations, the "business judgment rule" (discussed later). In the next section these obligations are defined and discussed separately.

Bundle of Obligations

The bundle of obligations is a creature of common law, that is, it was created by courts in many decisions over many years. Initially, the fiduciary duty is an obligation of the trustee to the beneficiary of a trust. By analogy, the duty has been extended to persons who act on behalf of others, including association board members (Di Lorenzo 1990, 3-5). Part V, "Condominium Management" Chapter 514A, Hawaii Revised Statutes, codifies a number of these basic duties and responsibilities.

Duty of Obedience. Board members are required to manage the affairs of the association in accordance with the condominium statute, declaration, bylaws, house rules, association policies and other applicable laws. In acting accordingly, a board member is said to have fulfilled the member's duty or obligation of obedience. Courts will usually defer to the board's decisions when made accordingly. Courts do not generally second guess the management decisions of board members.

It is advisable that directors and officers of the association regularly review their duties and responsibilities specified in the condominium statutes and rules as well as in the governing documents. The statutory duties and responsibilities were discussed in the Hawaii Real Estate Commission's publication, *Condominium Board Members Powers and Duties* (1991). Updates of the condominium statute are required by statute to be provided to all board members at association expense. The condominium statute may also be reviewed at your local library, or an unofficial reprint of Chapter 514A, and an official version of its administrative rules may be obtained from the Cashier's Office, Department of Commerce and Consumer Affairs, 1010 Richards Street, 3rd Floor, Honolulu, Hawaii 96813.

Examples of Obedience:

- Conducting a reserve study in compliance with §514A-83.6, HRS;
- Mandating the removal of a patio awning in accordance with the adopted administrative rules;
- Initiating collection procedures for unpaid assessments against a board member in compliance with the statutes and bylaws;
- Requiring that conflicts of interest be disclosed prior to the vote in accordance with the condominium statute.

Duty of Diligence or Due Care. This duty requires that each board member exercise due care in the performance of managing the affairs of the association. It is a standard of conduct for avoiding negligence (Di Lorenzo 1990, 3-13). Sometimes this duty is stated as requiring a board member to act as an ordinary reasonably prudent person would act in similar circumstances. Similar circumstances include acting like another reasonable prudent volunteer board member would under like situations.

Examples of Diligence:

- Gathering (researching, investigating) all necessary information for decision making;
- Consulting the opinions of appropriate professionals where necessary (i.e. legal counsel, engineers, architects, managing agents, parliamentarians, certified public accountants, etc.);
- Making an assessment for an anticipated maintenance problem;
- Checking the license status of a contractor the board intends to hire;
- Conducting a reserve study of association property;
- Preparing written procedures for evacuating residents in time of structural failure, e.g., fire, earthquake, elevator failure;
- Responding promptly to an owner's complaint and conducting all necessary follow up.

Duty of Loyalty. Simply viewed, loyalty means making decisions for the benefit of the association and not for the direct or indirect benefit of oneself, another board member, or a select group of association members. The duty includes the obligations:

- to refrain from competing with the association; e.g., abstaining from bidding against the association at a foreclosure sale on a unit the association is attempting to buy, abstaining from bidding against the association in its efforts to acquire a piece of real property on which to erect a tennis court (where such acquisition is permitted);

- to refrain from taking advantage of an association opportunity; e.g., hiring a person as a full-time employee for one's own business when the association still has that person under active consideration as a full-time employee;

- to refrain from acquiring any real or personal property when one has reason to know that the association is interested in buying it (where such acquisition is permitted), e.g. submitting a bid for a foreclosed apartment when the association passed a resolution to acquire the apartment for use by its resident manager;

- to avoid conflicts of interests; e.g. abstaining from voting to purchase insurance from a firm in which one is a shareholder (Natelson 1989, 482).

- to manage the affairs of the association fairly.

Examples of Loyalty:

- Voting to deny an owner's request for alterations to the exterior of its unit based on the project documents and a set criteria even though the owner is a friend and business associate.
- Initiating assessment proceedings against a board member in accordance with:
  - a board approved criteria;
  - governing documents; and/or
  - statutes.

Avoiding Conflicts of Interest. In making decisions for the benefit of the association, board members should avoid conflicts of interest.

> *"Courts have defined a conflict of interest as a situation in which a duty to one leads to disregard of a duty to another. U.S. v. Miller, 463 F. 2d 600 (1st Cir. 1972). In other words, a conflict of interest exists when some outside influence affects or may affect the ability to make an unimpeded, independent decision in a particular situation or when an individual owes duties to separate entities whose interest conflict. Whether or not a specific situation constitutes a conflict of interest is a factual question which must be answered on a case-by-case basis.. . . ." (Sellers and Lazega 1991, 2).*

In general, where a conflict of interest exists, the condominium statute in Hawaii states that a director is to:

(1) abstain from voting on any issue before the board (§514A-82(a)(13), HRS); and

(2) disclose the nature of the conflict prior to a vote and have the minutes reflect that a disclosure has been made.[4] (§514A-82(b)(5), HRS).

Each board should review the association's governing documents for further requirements and guidance in handling conflicts of interest. Some govenance documents specifically prohibit voting on a conflict of interest. Although, §514A-82(b)(5), HRS, appears to allow a board member with a conflict of interest to vote after the member discloses the conflict, *Robert's Rules of Order*, appears to provide a better practice:

"Abstaining from voting on a question of direct personal interest.

> **No member should vote on a question in which he [she] has a direct personal or pecuniary interest not common to other members of the organization." (Roberts 1990, §44, 402)**

Nevertheless, a reoccurring question in many situations of alleged conflicts of interest relates to:

What is direct personal or pecuniary interest?

The answer often depends on the circumstances and facts for a particular situation.

Potential Conflicts. Not all potential conflicts of interest become actual conflicts of interests requiring disclosure. Nevertheless, potential conflicts of interests should be monitored for ripeness into an actual conflict of interest.

Potential conflicts of interest exists where there is a possibility that a board member's interests (financial, social, personal, or otherwise) would at some point in time conflict with the association's interests. Examples of such include:

- a board member having a financial interest in a landscaping company although the company is not seeking the business of the association;
- a board member having a financial interest in or is an employee of a managing company although the company is not seeking the business of the association; and
- a developer appointed director when the association's management goals and the developer appointed director's management goals are the same.

The potential conflicts of interest discussed above mature into actual conflicts of interest when the landscaping company or the management company considers entering into a business relationship with the association. An association is concerned with obtaining the best service as cheaply as possible. The association must consider all bids for the services. However, when a board member has an interest in the company seeking the association's business, the member's interest is in seeking the highest price for the company's service. Thus, under such circumstances, the potential conflict of interest discussed here has matured into an actual conflict of interest.

Suggestions for Handling Conflicts of Interest

1. **Board development, if none exists, of written policies and procedures to follow when apparent or actual conflicts of interest arise.** Such procedures, at minimum, should implement the abstention and disclosure requirements as set forth in §514A-82(a)(13), and §514A-82(b)(5), HRS.

2. **At board meetings, the association's presiding officer should inquire whether any board member has or anticipates any actual or potential interest in the outcome of the board decision which might create a conflict of interest (financial or otherwise).** How often this procedure should be utilized is a decision to be made by the board.

The minutes of the board meeting should note the presiding officer's call for declaration of conflicts.

Suggestions for Handling Conflicts of Interest (continued)

3. **When an actual conflict arises,** the board member, prior to the vote on the issue, should:
   - disclose all material information regarding a conflict to the board, including for example the financial, friendship, or blood relationship of the board member to a vendor; the rebates, kickbacks, or compensation that a board member may receive from vendors that the condominium managing agent or association may hire.
   - abstain from voting or deliberating on the transaction;[5]
   - refrain from influencing the remaining board members (directly or indirectly); and
   - remain loyal to the association in all conflict situations.(Sellers and Lazega 1991, 8)

Every declaration and disclosure of any conflicts of interest should be noted in the board minutes.

4. **When a subject matter involves a transaction with a board member,** the board may (where permitted by the condominium governing documents) consider referring the matter to a committee of disinterested board members and owners. The board should instruct this committee to make recommendations about the fairness of the transaction and the best interest of the association.(Sellers and Lazega 1991, 8)

Duty of Good Faith. The duty of good faith is generally understood as an obligation to act with an honest belief that the action taken is necessary for the benefit of the association. In contrast to an action that is maliciously aimed at another unit owner or designed to take advantage of another unit owner (Di Lorenzo 1990, 3-15).

One commentator has concluded that the corporate case law suggests that good faith is indicated by the following conduct:

- being "disinterested" in the transaction, neither appearing on both sides of the transaction nor expecting to derive any personal benefit from the transaction (over and above that which would be derived by an owner);

- non-egregious, namely, engaging in conduct which a person of sound ordinary business judgment would have; and

- exercise of independent judgment, not dominated by another director (Di Lorenzo 1990, 3-15).

Another author includes in the obligation of good faith the avoidance of discriminatory, arbitrary, capricious, wanton, or malicious conduct (Natelson 1989, 478).

Examples of Good Faith:

- Approving a higher bid for repaving the driveway because the proposed materials were of a higher quality rather than approve the next lower bid.
- Exercising independent judgment in approving the salary of a director (of a for-profit corporation) despite the fact that the board member trusted and respected the director. *Lussier v. Mau-Van* 4 Haw. App. 359, 388, 667 P. 2d 804 (1983).

Conduct Expected of Board Members in the Rule Making and Enforcement Arena

Condominium associations are "volunteer legislatures, mini- or quasi government bodies." Thus, the "standard of reasonableness" guides their proposed rule making and enforcement decisions.

> *"Inherent in the condominium concept is the principle to promote health, happiness and peace of mind of the majority of unit owners since they are living in close proximity and using facilities in common. Each owner must give up a certain degree of freedom of choice which he might otherwise enjoy in separate, privately owned property." Hidden Harbor Estate Inc. v. Norman,* 309 So. 2d 1809 (Fla. DCA 1975).

> *"The uniqueness of the condominium concept of ownership has caused the law to recognize that each unit owner must give up some degree of freedom of choice." Association of Owners of Kukui Plaza v. City and County of Honolulu,* 7 Hawaii App. 60, 742 P.2d 974, (1987).[6]

When boards adopt rules promoting the health, happiness and peace of mind of the majority of unit owners they must recognize that each unit owner must give up some degree of freedom. Boards adopt and amend rules and enforce them. The courts usually defer to the board's decisions and actions in this area when the decisions have been reasonable, not arbitrary or capricious.

What is "reasonable'?

Guidance as to what "reasonable" means can be found in the reported court decisions of this state, other states, and in the literature:

McNamee v. Bishop Trust Company Ltd. In the Hawaii Supreme Court case *McNamee v. Bishop Trust Company Ltd.*, 62 Hawaii 397, 616 P. 2d 205 (1980), the court affirmed the trial court's decision and upheld the managing committee's denial of the owners (the McNamees) application for a second story addition to their home in the Wailupe subdivision.[7]

In applying the test of reasonableness and good faith, the court appeared to focus on the fact that the managing committee employed a uniform and consistent process in reviewing applications.

Hidden Harbor Estate Inc. v. Norman. In the often cited case of *Hidden Harbor Estate Inc. v. Norman,* 309 So. 2d 179 (Fla. DCA 1975), the Florida Court of Appeals, in upholding an incorporated association-made rule banning the consumption of alcohol in the association clubhouse, broadened the district court test and held further that the test of reasonableness includes: " If a rule is reasonable, the association can adopt, if not, it cannot."

Warren Freedman and Jonathan B. Alter, authors of the *The Law of Condominia and Property Owners' Association,* have also provided guidance on what is reasonable in their summary:

- The rule must have been adopted in a good faith effort to enhance the purposes of the condominium;
- The rule must in fact represent a reasonable means of accomplishing that purpose;
- The means employed by the rule must not conflict with any provision of the various documents in force [it must be based on and implement a provision of the declaration and or bylaws]; The rule must be consistent with sound public policy [it cannot contradict any state, county, and/or federal laws and rules] (Freedman and Alter 1992, 80).

Wayne Hyatt, writing on this topic, comments on the criteria for rule making as ". . .courts have not considered a direct constitutional challenge to an association's action, however, the possible contexts for such an attack are most intriguing,

and the courts are increasingly applying standards of reasonableness and due process in testing the rule-making and enforcement authority of associations. . . ." (Hyatt and Rhoads 1976, 924).

Trends to Watch

The California District Court of Appeals, in the case of *Nahrstedt v. Lakeside Village Condominium,* 9 Cal. App. 4th 1,11 Cal. Rptr. 2d 299 (Cal. Ct. App. 1992).[8] examined the condominium's governing document's "no pets" restriction and the unreasonable interference it may impose on the apartment owner's ability to use and enjoy her condominium unit. In discussing the possibility that the blanket restriction of "no pets" may be unreasonable as applied to the apartment owner keeping her cats inside her unit only, the court then discussed the possibility that the rule which the board adopted to implement the restriction in the common areas was inapplicable to keeping pets inside her unit.

Hawaii law differs as to pets. §§514A-82.5and 82.6, HRS.

In the rule making area, boards and apartment owners may see emerging, more intrusion by courts in examining the reasonableness of a rule as applied to an apartment owner's use and enjoyment of the condominium unit.[9]

> ***Plaintiff's condominium home is her castle and her enjoyment of it should be by the least restrictive means possible, conducive with a harmonious communal living arrangement. Nahrstedt v. Lakeside Village Condominium,* 9 Cal. App. 4th 1, 11 Cal. Rptr. 2d 299 (Cal. Ct. App. 1992), 309.**

Randolph C. Gwirtman suggests that New York courts use a shifting two-tier test in scrutinizing board rule making decisions. He suggests that the courts initially apply the business judgment rule in scrutinizing the propriety of a board decision. However, once the court's examiniation of the board decision indicates that the issue involves a habitat issue, the courts should shift the burden to the board to demonstrate that their decision was reasonable, not arbitrary or capricious and within the scope of the board's power. Gwirtman opines that the shifting two-tier approach minimizes the abuses of entrenched boards, whose decisions for their associations may be guided by self interest and not the association's interest (Gwirtman 1993, 1021).

Suggestions for Rule Making:

The following **non-exhaustive** checklist, may be used by board members as a beginning for adopting, amending, and enforcing administrative house rules.

Do the rules and enforcement decisions:

- fall within the authority of the condominium statutes, other applicable laws, and governing documents;
- implement provisions of the condominium statutes, other applicable laws, and governing documents;
- advance the purposes of the association;
- apply equally to all members (no special interest groups have been treated differently);
- appear to be made in the best interest of the association and not in the best interest of oneself or family; basically free of conflicts of interest;
- comply with other applicable law and public policy not unconscionable; (Freedman and Alter 1992, 80)
- apply reasonably pursuant to effective notice; and
- appear to be made pursuant to a reasonable procedure in compliance with the governing documents e.g., the bylaws.

Conduct Expected of Board Members in Managing the Business Affairs of the Association

Board Members are expected to make business decisions of the association in good faith and in accordance with the Business Judgment Rule.

The Business Judgment Rule recognizes that despite their best efforts to act reasonably, board members may not make the right decisions.

Basically, when board members keep to their fiduciary promises, **each may be protected by the business judgment rule from personal liability.**[10]

The Business Judgment Rule Includes:

- Acting in good faith for an association purpose (not in self-interest);
- Acting with such care as an ordinary reasonably prudent person in a like position would under similar circumstances; and
- Acting in a manner believed to be in the best interest of the association.

The process followed in reaching a decision may be as, or more important than the decision itself.

The rule is a court formulated legal doctrine that restrains a court from overturning the management decisions of a corporation's [11] board of directors or holding the board liable for any loss resulting from those decisions (Di Lorenzo 1990, 4-1). The rule may also be viewed as a standard by which to measure a board member's adherence to his or her fiduciary duty; that basic bundle of expected conduct (previously discussed starting at page 4). The rule recognizes that board members are volunteers with a big job, who do their best to carry out that job. However, at times in carrying out the big job, a member may make an honest mistake. Thus, when the mistake is indeed an honest mistake the courts **do not usually** hold the board member personally liable.[12]

Courts will not second guess the decisions of the board except in situations when there is a showing or demonstration of fraud, self-dealing, dishonesty or incompetence on the part of a board or board member.

In connection with for-profit corporations, the business judgment rule is a recognized doctrine in Hawaii. Hawaii's Intermediate Court of Appeals in *Lussier v. Mau-Van Development, Inc.*, 4 Hawaii App 359, 667 P2d 804 (1983) has applied this doctrine in reviewing the appropriateness of the decisions made by corporate boards of directors. The court, in deciding this case defined the business judgment rule as:

> *"The business judgment rule was developed 'as a device for insulating corporate decision makers, both officers and directors, from personal liability for mistakes of business judgment arrived at in good faith. (Citations omitted) A traditional definition of the rule is:*
>
> > *Ordinarily neither the directors nor the other officers of a corporation are liable for a mere mistake or error in judgment, either of law or fact. In other words, directors of a commercial corporation may take chances, the kind of chances that a man would take in his own business. Because they are given wide latitude, the law will not hold directors liable for honest errors, for a mistake in judgment, when they act without corrupt motive and in good faith, that is for mistakes which may properly be classified under the head of honest mistakes. (Citations omitted)*
>
> *Professor Dyson phrases the rule thusly:*
> *The director who diligently attends to his duties and exercises his best business judgment on the questions facing him will not be considered negligent even if his judgment is faulty. . . ."(Mau-Van supra 375).*

The court, in *Lussier v. Mau-Van Development, Inc., supra,* also discussed a section of the Hawaii Business Corporation Law, §416-91.5(c)(e) and (f), HRS, in conjunction with the business judgment rule. That discussion gives board members guidance as to the circumstances when the business judgment rule may shield them from personal liability:

> ***"By combining the requirement of good faith with the statement that a director must act 'with such care as an ordinarily prudent person in a like position would use under similar circumstances,' Section 35 [of the Model Business Corporation Act] incorporates the familiar concept, that these criteria being satisfied, a director should not be liable for an honest mistake of business judgment. A director attempting to create profits for his corporation will frequently make decisions involving risk for the enterprise. No personal liability should be imposed upon him in the event his good faith decision, in the exercise of business judgment, later seems to have been erroneous. (Citations omitted). Thus, §416-91.5(c), HRS, leads us to the common law 'business judgment rule.' . . ." ((Mau-Van supra 374).***

For associations which are incorporated as non-profit corporations, the protection of the business judgment rule apparently is provided by statute (§§415B-6 and 415B-158.5, HRS).[13] Although §415B-6, HRS, provides for indemnification of board of directors, the relevant provisions of §415B-6, HRS, sounds or appears similar to the spirit of the business judgment rule.

Because few reported cases in Hawaii discuss the business judgment rule and actions taken by board members of associations of apartment owners, it becomes necessary to look for guidance on this subject in court cases reported in other states. Following are examples of situations, from other states, where the courts have concluded, among other things, that the board member's conduct was shielded by the business judgment rule and other examples where the conduct was not shielded.

Examples from Other States:

The Business Judgment Rule Has Been Available When . . .

A newly elected board (without obtaining the consent of the majority of the owners) voted to specially assess the owners $100,000 to remedy the following emergency state of affairs (action permitted in the bylaws):

- depletion of the budget by $60,000 for expenditures made for a prior year;
- association's indebtedness to vendors and suppliers in the amount of $68,449.01;
- association's indebtedness to the managing agent for monies advanced for outstanding bills and management services;
- association's indebtedness of $40,000 for fuel and electricity (association did receive a termination of service notice);
- building's dire need of repairs (air conditioning, heating and fire systems) estimated at $21,000;
- weakened state of the building's "curtain wall" requiring immediate attention; the weakened wall had caused 60 units to suffer water damage due to leakage whenever it rained (condition had been deteriorating for several years because of lack of funds); and
- the inability of past due maintenance and current maintenance payments to provide the large amount of funds required to address the serious financial needs of the association.

In determining that the board had authority to impose a special assessment without the consent of a majority of the unit owners, the court discussed the application of the business judgment rule and the following factors as indicative of the board's reasonable and good faith conduct:

- the board's consultation with legal counsel as to the authority of the board to impose a special assessment for emergency situations;

- the board's deliberations and discussions about the facts surrounding the condominium's financial problems and physical state of the building;
- the board's examination of an audit from an accounting firm confirming the dismal financial status of the association; and
- the board's consideration of alternative ways of paying overdue bills; and consideration of alternative ways of raising money. *Papalexiou v. Tower West Condominium* 401 A.2d 280 (N.J. 1979). (Freedman and Alter, 1992, 90).

The court indicated the import it places on a condominium association board's fact finding and decision making processes.

In a case of first impression in Hawaii's jurisdictional neighbor state of Washington, the court found no evidence of bad faith or improper motive on the part of board members which would have amounted to a breach of a duty owed. In the case of *Schwarzmann v. Ass'n of Apartment Owners,* 655 P.2d 1177, (Wash. App. 1982),[14] the court noted that the board of this unincorporated association responded in a timely manner to a complaint by an owner of spots in their ceiling (noted in November 1978). The following examples of board conduct provide guidance to other boards as to the circumstances in which the business judgment rule will protect the board:

- the board sent the building chairman to look at the spots several days later after the receipt of the complaint (board apprised of complaint at its December 1978 board meeting);
- the board hired a roofing company at the end of December 1978 to inspect the problem in response to owner's complaint of water leaking from the ceiling onto furniture and carpet. The roofing company concluded that the problem was caused by condensation occurring in the attic over the unit. (roof and attic areas above the units were part of the common areas);
- at the annual meeting in January 1979, condominium owners instructed the board to hold an emergency meeting to evaluate owner's reported water leaking problem;
- the board had the building chairman inspect the unit again with a representative from a mechanical company who concluded that the problem was not caused by the heating system, air conditioner or any condensation from the unit.

Since the court found that the board acted in good faith in investigating and responding to the owner's complaint, the court did not second guess the judgment of the board in it's response to the apartment owner that it did not cause or have any responsibility for the problem.

The Business Judgment Rule Has Not Been Available When . . .

Associations and their directors:

- acted negligently [failed to act with due care under like circumstances] (Freedman and Alter 1992, 90);
- failed to act reasonably to investigate a claim against the association;
- failed to investigate the background of prospective contractor and employee;
- signed overpriced contracts due to failure to obtain competitive bids;
- failed to obtain professional advice;
- failed to monitor expenditures and assessment delinquencies.

Court decisions, in this area, also indicate that a decision or action will not be protected by the business judgment rule where there is a showing of fraud, self-dealing, dishonesty or incompetency on the part of the board or board member.

In summary, the case law and literature appear to provide the following guidance about the availability of the business judgment rule when the decision is based on:

- good reasonable investigation, research and data gathering appropriate to the circumstances;
- reasonable reliance on professional advice where needed; reasonable reliance excludes unwarranted reliance where the board member knows or is aware of circumstances which would make the information unreliable or incorrect;
- the mandates of the condominium governing documents and applicable laws and rules;
- a proper motive-not motivated by self-interest;
- a rational belief that the decision made is in the best interest of the association and advances the purposes of the association;
- a grant of authority to make such decisions;
- due care and the independent judgment of a board member.

When a board or member is in doubt about the appropriateness of any of their decisions, it is highly recommended that the board member seek the advice of a duly licensed attorney or other qualified professional. Inaction or deciding not to make any decision when one is warranted under the circumstances may be a breach of the board member's fiduciary duty.

Examples of Specific Areas of Director Responsibility and Liability

"The [fiduciary] duty to act in good faith and with diligence, care, and skill [obedience, undivided loyalty] does not apply only to the "business" decisions and activities of the association. This duty also applies to the governmental or regulatory decisions that the board of directors must make. . . ." (Hyatt 1989, 73).

The conduct expected of board members in carrying out their responsibilities in managing the affairs of an association have been explained and illustrated. To reiterate, that expected conduct consists of a bundle of obligations commonly referred to as the "fiduciary duty." Breach of this high standard of conduct may subject each of the directors or all of them to individual liability, despite the fact that each acts on behalf of the association. (Hyatt 1989, 70).

Chapter 514A, HRS, imposes on board members several responsibilities for managing the affairs of the association. Other responsibilities, not prohibited by Chapter 514A, HRS, may also be imposed on board members by the condominium's declaration, bylaws, house rules and in some cases by court decisions.

Each board member should review the condominium's declaration, bylaws, and house rules for additional responsibilities each must carry out.

The board's statutory responsibilities, for educational purposes, are again noted in this section. Other examples of responsibilities generally imposed by most condominium declaration, bylaws, and house rules are also listed in this section. A board member's fiduciary duty in carrying out any responsibility includes, at minimum, following those procedures specified in the statute, declaration, bylaw, or rule.

Basically, each director owes the association a fiduciary duty in the performance of the following responsibilities (a non-exhaustive listing):

Some responsibilities imposed by statute and by the condominium governing documents are discretionary on the part of the board. Nonetheless, if a board elects to undertake the responsibility, each director must do so as a fiduciary.

- maintaining, repairing and replacing association property including the negotiating and executing of contracts for such [15] (§514A-83.6, HRS);
- giving of, at least 30 days, prior written notice of any maintenance fee increase (§514A-92.2, HRS);
- exercising the board's right to change the use of or lease common elements, with proper approvals (§514A-13(d), HRS);
- opting to authorize the installation of separate metering for utilities with restrictions (§514A-15.5 (b)HRS);
- conducting board elections (§§514A-82((a)(1),(15),(16),(17) & (b)(3), HRS) and using proxies (§514A-82(b)(4), HRS);
- disclosing conflicts of interests (§§514A-82(a)(13) and (b)(5), HRS);
- managing the association's fiscal affairs including:
  - adopting and distributing an annual budget (§514A-83.6, HRS),
  - conducting and funding a reserve study, maintaining an adequate reserve fund (§514A-83.6, HRS),
  - assessing unit owners (including enforcing collection of assessments) (§514A-15, HRS),
  - disbursing assessments, depositing and investing of association funds (§514A-97(c), HRS),
  - electing to borrow money for the repair, maintenance, etc. of common elements with 50% owner approval (§514A-82.3, HRS).
- keeping safe association funds including the prohibition of transferring funds between accounts by telephone (§§514A-97(d) and 514A-15, HRS);
- maintaining and making available to the unit owners, with restrictions:
  - books and financial records (§§514A-83.5 and 514A-85, HRS);
  - association and board minutes (§§514A-83.4 and 514A-83.1, HRS),
  - membership lists (§514A-83.3, HRS),
  - proxies and other related election records (§514A-83.5, HRS),
  - summary of insurance information (§514A-86, HRS),
  - a copy of the association's annual audit, a summary of it, or if the audit has not been completed at the time of the request, a current financial statement for the association (§514A -96(b), HRS) available to the unit owners with restrictions (§§514A-83.4 and 514A-83.5, HRS;
- amending governing documents in accordance with statutory requirements, including the required percentage of votes (§§514A-81; 514A-82(b)(2), and 514A-82.2 HRS);

- adopting and amending administrative rules for the operation of the association and use of the common elements (§514A-82(a)(9), HRS);

- enforcing covenants, bylaws, and administrative provisions (§§514A-88 and 514A-82(a)(18) HRS);

- reviewing requests for approvals for additions and alterations to be made within the limited common elements or within an apartment (§§514A-13, and 514A-15, HRS);

- scheduling and conducting association and board meetings (§§514A-83.1, and 514A-82(a)(15), (16), and (17), HRS);

- protecting condominium owners and property including:
  - providing for emergency entrance and repairs and other repairs for the operation of the project (§§514A-82 (b)(6), and 514A-13(f), HRS), bringing where appropriate and settling suits in such matters including but not limited to the common elements, the roof and structural components of a building, mechanical, electrical and plumbing elements,

  - conducting background checks of employees such as security guards or managers or other positions which would allow the employee access to keys or entry into units (§§514A-82.1 and 846-41, HRS),

  - purchasing and maintaining a policy of fire insurance to cover the common elements and all exterior and interior walls, floors, and ceilings of the condominium project (flood insurance if the project is located in a flood hazard area (§514A-86, HRS),

  - providing fidelity bonding for those specified individuals who handle the funds of the association (§514A-95.1, HRS),

  - conducting a yearly audit and one yearly "unannounced" verification of the association's cash balance by a public accountant (§514A-96, HRS);

- complying with provisions for resignation and removal of directors where appropriate (§514A-82(b)(1), HRS);

- deciding whether to hire a managing agent (§514A-95, HRS); and

- registering annually the association of apartment owners with the Real Estate Commission and obtaining a fidelity bond (§514A-95.1, HRS).

The Association's Agents

Boards may delegate some of their duties to officers, employees, and managing agents. Officers and managing agents are agents of the association. They are fiduciaries with respect to any property they manage. The duties that can be delegated are usually indicated by the condominium governing documents (articles of incorporation [where applicable], and bylaws). Boards are advised to review the required documents to determine which duties may be delegated.

Although a board can delegate its duties, it cannot avoid responsibility for carrying out its duties or for the non-performance of the duties thereof. For additional discussion of this topic, see the Real Estate Commission's publication, *Condominium Board Members Powers and Duties.* (HREC 1991,17, 19 & 20) A board cannot simply hire an employee or retain a management company and place blinders on as to what these employees and agents may be lawfully or unlawfully doing. Association directors who fail to evaluate and su-

Suggestions for Supervision of Officers, Employees, and Agents

1. Give clear directions to association officers, employees and agents as to the scope and limitations of their duties and responsibilities;
2. Review the performance of the association's agents and implement procedures to prevent the occurrence of agents' performance of their duties outside the scope and authority delegated to them;
3. Act promptly to eliminate the employees and agents acting outside the scope of the employment or agency.

pervise the performance of their agents and employees may find themselves personally liable for the acts of the agent and employees. For example, an association may find itself obligated to a long term pool maintenance contract by the actions of its agents or employees, even though the board if asked directly, would not have approved the contract.

Providing Safe Harbors for Board Service — Directors' and Officers' Liability Insurance and Indemnification Provisions

To encourage condominium owners to serve on boards without excessive fear of personal liability, the condominium's governing documents should provide that the association will be responsible for the reimbursement (indemnification) of certain losses, and expenses including costs and reasonable attorney's fees, incurred by a board member in defending him or her self for their good faith decisions made while serving on the board.

However, an indemnification provision by the association itself may be inadequate protection. The association may not have the funds to indemnify the director and officer when the need arises. Thus, governing documents providing for indemnification and requiring the association to obtain directors' and officers' liability insurance appears to be the better vehicle for providing protection for board member liability. (Bailey Arter and Hadden 1989, 26) However, directors' and officers' insurance is not a cure-all, in some instances an indemnity provision may include coverage for an area not covered by the directors' and officers' insurance policy. [16]

Nevertheless, directors' and officers' insurance does provide the following:

- some assurance to the association and board members, that when the need arises, it has a financial resource for reimbursing board members for losses and expenses incurred for good faith actions taken as a board member, e.g. legal fees, costs of defending the suit; and
- protection against a different composition or attitude of the organization's board; a board may no longer be sympathetic to the prior officer and board member, and thus, may not authorize the indemnification.(Bailey 1989, 26)

For associations with governing documents providing for indemnification of board members but unable to obtain directors' and officers' insurance coverage, such associations must investigate other funding sources. e.g., self-insurance, surety bonds, guarantees by other agencies, etc.

Suggestions For Providing Legal Protection for Board Service

1. Maintain liability and directors' and officers' insurance coverage to ensure that a funding source is available for reimbursing a board member for expenses, judgments, legal fees, fines, settlement and other actual amounts reasonably incurred in connection with the member being threatened or sued for actions taken as a board member.

2. Include and/or amend the bylaws providing for, at minimum, the indemnification provisions in the Hawaii corporate and non-profit statutes (§§415B-6, 158.5, and 415-5(b), HRS) which briefly provide indemnity when the person:[17]
   - is or was an agent of the corporation;
   - acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interest of the corporation; and
   - with respect to any criminal proceeding, had no reasonable cause to believe the conduct of the person was unlawful.

Caveat: there may be no indemnification if it is determined that the person is liable for negligence or misconduct in the performance of the person's duty unless the court in the interest of justice and fairness deems that indemnification is appropriate under the circumstances. (§§415B-6(c), and 415-5(c), HRS)

3. Include in, or amend the bylaws providing for a case-by-case determination, the making of the indemnification upon a finding that the indemnification of the agent is proper in the circumstances; the agent has met the applicable standard of conduct described previously. The condominium governing documents or agreements may provide for indemnification upon a determination by an independent legal counsel that the agent acted properly in the circumstances (§415B-6 (g), HRS).[18]

4. Incorporate an unincorporated condominium association as a non-profit corporation; board members of non-profit corporations are generally not liable for their good faith actions or omissions, except if the actions or omissions are grossly negligent.[19]

Incorporation impacts significantly on the operations of the association, boards are advised to seek qualified professional advice prior to deciding to incorporate as a non-profit corporation. In some cases, the bylaws may have to be amended in accordance with the required percentage of votes.

5. Review existing bylaws and other governing documents, records of board actions (including minutes, book of resolution, and reports), for any existing provisions, limitations and procedures in connection with indemnification.

Concluding Suggestions for Minimizing Directors' Personal Liability

1. **Serve one principal—the association.**

2. **Make decisions for one mission—health, happiness, welfare of the condominium association and the preservation of the condominium common elements for decades to come.**

3. **Rise above self-interest.**

4. **Make decisions based on information, research, professional consultation where required; in arriving at a decision act independently and not at the direction and dominance of another board member.**

5. **Act prudently in making decisions, do what the "Reasonable Person would suggest and do under like circumstances."**

6. **Be knowledgeable of the affairs of the association, this includes having a working knowledge of:**

   - the association's minutes, policies and governing documents—declaration, bylaws, and house rules; and

   - the condominium statute, Chapter 514A, HRS, and other related administrative rules, decisions and policies of the Real Estate Commission.

7. **Be responsive to the residents you serve. This may include surveying the residents' opinions on appropriate issues.**

8. **Consult experts when you are unfamiliar with the issues; i.e., attorneys specializing in condominium governance and administration, accountants, reserve specialists, contractors, electricians, plumbers; etc.**

9. **Consult more than one expert to insure that you have gathered information on which to base your decision; but remember that intentionally shopping around for a pre-selected biased opinion may not be deemed reasonable.**

10. **Attend continuing education courses and other seminars relating to managing the affairs of the association.**

11. **Keep abreast and be aware of court decisions, legislation, new federal and state laws, and county ordinances.**

Concluding Suggestions for Minimizing Directors' Personal Liability (continued)

12. Hire managing agents and resident managers after a thorough investigation including applicable license history, reputation in the community, and reasonable prices for professional services rendered (seek more than one bid for any job).

13. Amend declaration and bylaws if necessary, to include provisions for the association to be responsible for costs and reasonable attorney's fees incurred in defending oneself for the good faith decisions made while serving on the board (association may provide for this by indemnification and directors' and officers' insurance).

14. Give clear directions to the association's officers, employees and agents as to the scope and limitations of their duties and responsibilities.

15. Review the performance of the association's agents and implement procedures to prevent activities beyond the scope and authority of the duties delegated.

Endnotes

Abbreviations

§ Section
HRS Hawaii Revised Statutes

Page in text — Note #

p. 1 — 1. In some instances, a case is included here because the court discussed some important law in connection with the case but the law may not be central to the court's decision.

p. 1 — 2. "Condominium associations may be organized as not-for-profit corporations, corporations for profit or unincorporated entities." (Poliakoff 1988, §10:3)

p. 2 — 3. Sometimes a board member's responsibility is explained in terms of the "Business Judgment Rule;" how would a reasonable board member act in similar circumstances. The "Business Judgment Rule" is discussed further at page 10.

p. 5 — 4. This provision was incorporated into the bylaws of all condominium projects existing as of January 1, 1988, and must be in all condominium projects created after that date. Section 514A-82(b)(5), HRS, is deemed to be retroactive to all condominium projects. However §514A-82(a)(13), HRS, applies only to condominium projects existing as of the date that it was enacted. For other projects not subject to §514A-82(a)13, HRS, the provisions of the condominium bylaws and declarations relating to conflicts of interests govern.

p. 7 — 5. Abstaining from voting on an issue where a director has a perceived or potential conflict of interest in contrast to an actual conflict appears to be the better practice. [Hawaii's condominium statute appears silent or open about requiring abstaining from voting in "perceived conflict" situations. §514A-82(b)(5), HRS.]

p. 8 — 6. But compare *Nahrstedt*, discussed at page 9, "Unit is my castle," and endnote #9

p. 8 — 7. Although this case did not involve a condominium association, the subdivision's association managed the affairs of the subdivision much like a condominium association of apartment owners. The association had a grounds committee, a managing committee whose responsibilities were to approve or disapprove architectural alterations, and a dog control committee. In affirming the trial court's decision, the court reasoned: "... The managing committee decision to reject the plaintiff's application was reasonable and made in good faith. . . ." (*McNamee* at p 410).

p. 9 — 8. Plaintiff, an apartment owner, in this case challenged a condominium restriction prohibiting pets in the condominium project and the authority of the board to levy monetary fines on homeowners who violate the restriction. The appeals court reversed the judgment of the lower court dismissing plaintiff's complaint and sent the case back for further proceedings.

p. 9 — 9. Hawaii's courts may follow the California courts in this area. Hawaii's condominium statute appears to echo the sentiments of the California courts in *Nahrsted*:

> Contents of bylaws. (a) The bylaws shall provide for at least the following:
>
> (10) The restriction on and requirements respecting the use and maintenance of the apartments and the use of the common elements, not set forth in the declaration, as are designed to prevent unreasonable interference with the use of their respective apartments and of the common elements by the several apartment owners. . . (§514A-82 (a)(10), HRS).

p. 10 — 10. It appears that Hawaii courts, unlike the courts of California, Florida and some other states, have not specifically articulated that it does or will follow corporate law principles in scrutinizing the business decisions of unincorporated condominium association boards. However, it is an educated guess, that Hawaii courts may follow another state's case law in allowing the application of as well as the protection of the business judgment rule

to unincorporated condominium board members' business decisions.

p. 10 11. Although the business judgment rule is a concept discussed in the corporation context, the operation of the rule may apply equally to the actions of the board of an unincorporated and non-profit condominium association. Courts in other states have done so.

p. 11 12. Even though it appears that there are no reported Hawaii court cases applying the business judgment rule to the conduct of an unincorporated condominium association board, the rationale of the doctrine also appears applicable to the conduct of boards of unincorporated associations.

"The skills required for the position do not require the board member to be blessed with unique talents found only in the board rooms of Corporate America." (Hyatt 1989, 213.)

p.11 13. A corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any proceeding (other than an action by or in the right of the corporation) by reason of the fact that the person is or was an agent of the corporation, against expenses, judgments, fines, settlements, and other amounts actually and reasonably incurred in connection with such proceeding if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal proceeding, had no reasonable cause to believe the conduct of the person was unlawful. . . . (§415B-6(b), HRS)

p. 12 14. In the jurisdictional neighbor State of Washington, the appellate court in *Schwarzmann v. Ass'n of Apartment Owners,* 33 Wash. App. 397, 655 P.2d 1177, (Wash. App. 1982), affirmed the trial court's granting a summary judgment in favor of the association board. In affirming the board's decision, the court applied the protection of the business judgment rule . This was a case of first impression for this state which involved the application of the corporate business judgment rule to an unincorporated condominium association. Seven members comprised the board whose responsibilities included the maintenance and repair of common areas of the condominium. The Schwarzmanns, owners of a unit in the Seattle Bridgehaven Association, noticed spots in their ceiling in November 1978. They reported this at the December 1978 Board meeting. The board responded several days later and sent the building chairman to look at the spots. At the time of inspection, the Schwarzmanns noticed additional spots on their ceiling. At the end of December, water leaked from the Schwarzmann's ceiling onto their furniture and carpet. In response, the board hired a roofing company to inspect the problem. The roofing company concluded that the problem was caused by condensation occurring in the attic over the unit. (roof and attic areas above the units were part of the common areas). The Schwarzmann reported the problem at the annual meeting in January of 1979. The condominium owners instructed the board to hold an emergency meeting to evaluate the situation. Three days later, the building chairman inspected the unit again with a representative from a mechanical company who concluded that the problem was not caused by the heating system, air conditioner or any condensation from the unit. The Schwarzmanns were unsatisfied with the progress of the board and had their attorney's send a demand letter. The board president sent a letter in response to the demand letter and essentially denied it was a problem which the association in managing the common areas caused or have any responsibility for. The Schwarzmanns, unsatisfied with the board's response sued the board for damages for diminished use of their unit, the interference caused to their daily lives and the pain and suffering, medical fees and costs. The appeals court held that the board members' actions fell within the parameters of the business judgment rule and that courts were reluctant to interfere with the internal management of the corporations and generally refuse to substitute their judgment for that of the directors. The court defined the business judgment rule much like the court in the *McNamee* case. In its holding it specifically stated at page 1181-1182:

"Like their corporate counterparts, condominium directors have a fiduciary responsibility to exercise ordinary care in performing their duties and are required to act reasonably and in good faith. (citing *Paplexiou v. Tower West Condominiums* 401 A 2d 280 (N.J. 1979).) The trial court found no evidence of bad faith or improper motive which would demonstrate that the board members breached a duty owned to the plaintiffs. Nor do we find any such evidence. Absent a showing of fraud, dishonesty or incompetence, it is not the court's job to second-guess the actions of directors.

Our review of the record on appeal reveals no evidence of ill-motive or recklessness on the part of the board. The board merely exercised its discretion, as duly-elected administrators of the condominium. A party is not liable for damages for emotional distress when it had a legal right to act as it did. . . Nor have the Schwarzmanns demonstrated that the board of directors acted unreasonably in how they handled the water problem. . . ."

p.14 15. Condominium governing documents usually provide that the condominium associations are responsible for the maintenance, repair and replacement of the common elements. This obligation is usually delegated to the association's board of directors and officers.

Failure to satisfy this obligation may result in liability to the association or an individual board member liability. In *Schmidt v. The Board of Directors of the Association of Apartment Owners of the Marco Polo Apartments and Marco Polo Management* Civil No. 87-15672 (First Circuit) discussed in *Schmidt v. The Board of Directors of the Association of Apartment Owners of the Marco Polo Apartments and Marco Polo Management* 73 Haw. 526, 836 P2d 479 (1992), decided September 15, 1992, the jury rendered a special verdict in favor of the Schmidts (apartment owners). The jury found the association 70 % and the Schmidts 30% legally responsible for the damages to the Schmidts' apartment and personal property. The Schmidts claimed that the condominium roof above their apartment leaked. The roof was a common area which the association had a duty and obligation to maintain, replace or restore, and which the association failed to correct. The Hawaii Supreme Court affirmed the trial court's order denying the Schmidts' claim for attorney's fees, costs and prejudgment interests. The court ruled that the Schmidts' claim was a garden variety tort claim and as such the claim did not seek to compel obedience to any provision of the condominium's declaration, bylaws, house rule or any other enumerated provision of Chapter 514A, HRS, for which attorney's fees and costs could be recovered by the apartment owner.

In *Raven's Cove Townhomes, Inc. v. Knuppe Development Company* 114 Cal. App. 3d 334, 171 Cal Rptr. 334 (1981), the court of appeals discussed the initial directors' individual liability for breach of a fiduciary duty. The fiduciary duty breached related to the board's failure to assess (according to the covenants, conditions, and restrictions) each unit for an adequate reserve fund for the purpose of maintenance and repair. These initial directors were owners of the development company and employees of developer.

In contrast, where association board members were individually sued for the damages caused to an apartment owner's furniture and carpet claimed to have been caused by water leakage coming from the common area of the roof, the appeals court affirmed the finding of the trial court in concluding that as a matter of law the individual board members actions fell within the parameter of the business judgment rule. The appeals court found no substantial evidence that the individual board members acted in bad faith, or somehow knowingly participated in or condoned wrongful or negligent conduct. *Schwarzman v. Ass'n Of Apartment Owners.* 33 Wash. App. 397, 655 P.2d 1177 (1982). See page 10 for a detailed discussion of the application of the business judgment rule.

p. 16 16. Section 514A-86 (b), Hawaii Revised Statutes, does not mandate the purchase of directors' and officers' liability insurance. The statute gives boards discretion in deciding

whether to purchase such insurance. The insurance premiums are a common expense.

p. 17 17. Both Hawaii's corporate and non-profit corporate statutes allow other indemnification rights provided by bylaws, agreements, vote of the members, or disinterested directors or otherwise.

p. 17 18. Other ways that a determination can be made:
- by the board by a majority vote of a quorum of directors not parties to the proceeding; and when there is no quorum by independent legal counsel in a written opinion;
- by [association] members; or
- or upon a determination made by the court in which the proceeding is or was pending. (§§ 415-5 and 415B-6, HRS).

p.17 19. The exception to the liability statute states in pertinent part:
§415B-158.5, "Exception to liability."HRS. Any person who serves as an officer or director to the corporation without remuneration or expectation of remuneration shall not be liable for damage, injury, or loss caused by or resulting from the person's performance of, or failure to perform, duties of the position to which the person was appointed, unless the person was grossly negligent in the performance of, or failure to perform, such activities. (Emphasis added.)

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The "author-date" form of citation has been utilized in this publication and consists of the author's last name, year of publication of the work and specific page, section or other element of the cited work (eg., Jones 1999, 125). "Author" means the name under which the work is alphabetized in this bibliography. Source consulted: *The Chicago Manual of Style,* 14th ed. 1993, (The University of Chicago Press, Chicago, Illinois).

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