A PRIMER ON
BOARD OF DIRECTORS’ FIDUCIARY DUTIES

Knowing What Is Expected Of You And Simple Tips For Complying

by

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"FIDUCIARY"
Of, relating to, or involving one that holds something in trust for another.

INTRODUCTION

If your best friend was going on a trip and left you her prized rose plant to care for while she was away, you would be a fiduciary -- you would be holding that plant in trust until the return of your friend. You would put the plant in a safe place where it would get enough light, but not too much. You would make sure that it gets watered, but not over watered. You would add any fertilizers or minerals to its soil to keep it vibrant and healthy. And, you would probably worry all the while you were taking care of it, because you are afraid that you aren't doing everything just right, and that if the plant were to wilt and die, you would feel just terrible. What's worse, regardless of how the plant may have died, since it was in your care, you would be blamed for its demise.

Being a member of a board of directors is really not that much different. You will be confronted with similar fiduciary obligations, responsibilities and worries. But just because you are blamed doesn't mean you are responsible or (curses! the "L" word) liable. You are not liable just because the plant dies; you are only liable if you breach your fiduciary duty and I am going to tell you how to avoid that fate.

In the next few pages, I will tell you, in simple English, about your primary fiduciary obligations as a director. And so you don't go away empty-handed, I will leave you a checklist of some basic tips for avoiding the pitfalls that can accompany these duties.

WHAT IS A FIDUCIARY?

A "fiduciary" is one who stands in a special relationship of trust and confidence with respect to his or her obligations to others. One who manages the property and/or affairs of another is a fiduciary and is subject to a high standard of care, similar to that of a trustee. An association plays an important role in what are typically public-service functions so that
it is, in a sense, a "mini-government" owing a duty of good faith and a fiduciary duty, not only to the association members as a group, but to the members individually.

**HOW IS A FIDUCIARY SUPPOSED TO ACT?**

A "fiduciary" should act in good faith and exercise basic duties of good management. "Good faith" is generally said to be that state of mind denoting honesty of purpose, freedom from intention to defraud and, generally, faithfulness to one's duty or obligation. "Good management" includes, for example, the keeping of adequate books, records, and minutes. Thus, acting as a "fiduciary" means acting prudently, fairly, with care and the use of your better judgment.

**ARE THERE FIDUCIARY OBLIGATIONS FOR CORPORATE DIRECTORS?**

It is a long established principle of corporate law that the business and affairs of a corporation and all corporate powers are to be conducted and exercised by and under the direction of a board of directors. (*Corporations Code* § 300[a]). This principle applies not only to for-profit business corporations but equally to public benefit corporations (*Corporations Code* § 5210) and mutual benefit corporations (*Corporations Code* § 7210). Under the *Davis-Stirling Common Interest Development Act* a community association, whether incorporated or unincorporated, may exercise the powers granted to a mutual benefit corporation. (*Civil Code* § 1361) The principle that all corporate powers are to be exercised by the board of directors is not unique to California corporation law; it is a virtually universal rule of corporation law in this country.

Under California law there are both for-profit and non-profit corporations and there are three types of non-profit corporations: public benefit (dedicated to some public purpose, such as health care) mutual benefit (dedicated to the mutual benefit of their members) and religious (churches). Community associations are usually organized as *nonprofit mutual benefit* corporations and, as mentioned above, regardless of whether they are incorporated or not, they may exercise the powers and duties of such corporations. (*Corporations Code* § 1363).

There are innumerable boards of directors in American society. They oversee multinational (business for profit) corporations, Philharmonics and Museums (arts organizations), professional sports organizations (athletic organizations), national universities (educational corporations) and homeowners' associations, to name a few. Regardless of their size or the composition of their membership, each shares a common bond with the others -- under law they all must act in the best interests of the organization they serve and all of its members, including the members of minority factions, to administer their powers for the common benefit.
WHAT ARE THE FIDUCIARY RESPONSIBILITIES OF A CORPORATE DIRECTOR?

Now that you understand that the affairs of a corporation are to be conducted by or under the direction of the board of directors, it is equally (or even more important) to understand that concomitant with this principle is the fact that the board is subject to a fiduciary duty to the corporation and its members in exercising its corporate powers. The board of directors of a community associations is charged with the responsibility of managing the affairs of the association on behalf of all the members. (Corporations Code § 7210). Like all corporations, a community association elects individual directors to exercise his or her individual judgment, in deliberation with other board members, on matters relating to the association's business and affairs. Into their hands is placed the governance and welfare of the association.

There are, generally speaking, two primary rules a board member is bound to follow: (1) put the interests of the association above your own personal interests and (2) alwasy exercise your prudent business judgment. These responsibilities are embodied in California law in Corporations Code § 7231(a), which provides:

A director shall perform the duties of the director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation, and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances. (emphasis added)

Association directors must be aware of the potential for liability for actions that may constitute conflicts of interests. If a court finds that the directors have breached their fiduciary duty to avoid such problems, it may rule the board's action invalid.

How might this come up?

It might come up in a decision to select a maintenance or repair contractor, or, for example, adopting a rule that gives special privileges to a class of owners of which you are a member. One example may be a board member who owns a management company who wants the board to hire his company (i.e., him) as the manager. other examples might be board members who are contractors, architects or landscapers who want the board to hire them to do work for the association.
These self-dealing situations should be avoided. The interested director (i.e., the director who wants him or herself hired to be hired by the board) should fully disclose to the other members the actual or potential conflict and should abstain from the vote. If the transaction is reasonable and just to the association at the time it is approved and the board was apprised of the interested director's conflict and that director abstained from the vote, then the transaction will not be voided.

The broader duty of a director, which includes the duty to avoid self-dealing, is the director's duty to act with ordinary care and inquiry, when required, in his or her decision-making. The director's duty of ordinary care and inquiry is codified in California's statutory law. (Corporations Code § 7231). The duty is owed to the association and to the association's members and it exists whether or not the directors receive compensation. Section 7231 of the California Corporations Code sets forth this fiduciary duty, which is imposed upon the directors of a non-profit, mutual benefit corporation, such as a homeowners association. A director must perform his or her duties

1. in good faith (i.e., sincerely and honestly);

2. in a manner the director believes to be in the best interests of the association; and

3. with such care as an ordinarily prudent person in a like position would use in similar circumstances.

"PRUDENT"
Using good judgment or common sense in handling practical matters; careful with respect to one's own interests.

The concept of "prudence" under California law focuses on the attributes of common sense, practical wisdom, and informed judgment. Under the above stated rule, a director has a duty of inquiry of others with particular experience or competence when the need is indicated by the circumstances, and a director's reliance is justified when he or she acts in good faith, under reasonable inquiry, and without knowledge that would cause such reliance to be unwarranted.

Examples of breach of the director's duty of ordinary care might include mismanagement of association funds, failure to enforce the governing documents, and
failure to maintain the premises so that property values depreciate, and failure for seeing that all statutory duties imposed on the association are complied with.

*How do you know you are doing the right thing?*

Now that you know that the law requires directors to act as ordinary, prudent business people, how do you comply.

There is an old saying that says --

"With hindsight, there is always a right answer. Unfortunately, hindsight always comes too late."

Like most of your day-to-day decisions, the right answer is not always obvious. But, the law does not expect from you nor does it require of you under your fiduciary role a right decision, especially when evaluated from a 20/20 hindsight perspective. Directors are allowed to make mistakes so long as your decisions are made complying with the Prudent Business Judgment Rule. Section 7231 of the Corporations Code provides that if a director complies with the "prudent business judgment rule" he or she has not breached a director's fiduciary duty.

The Prudent Business Judgment Rule is founded on the concept that directors of community associations are not guarantors of the success of the association and are not liable for mere mistakes in judgment. The law recognizes that directors must sometimes make difficult cost/benefit decisions and the law will not second-guess those decisions as long as the directors satisfied their duty to act with ordinary care and inquiry.

An additional reason for the business judgment rule, which is particularly applicable to homeowner association directors, is that because their decisions often involve complex considerations, including multiple, personal viewpoints and interests, liability for mere "bad" decisions would likely adversely affect the decision-making process by deterring forthrightness and finality, and it would discourage competent people from becoming directors.

A final reason is that courts are made up of judges who interpret and enforce laws. Judges are not in the business of and they do not want to be making business judgments. Thus, while they can easily judge whether you complied with the Prudent Business Judgment Rule in making your decision, they do not want to evaluate the merits of your your decisions.

The Prudent Business Judgment Rule is also premised on another notion -- that the
directors to whom the management of the corporation has been entrusted are primarily responsible for judging whether a particular act or transaction is one which is helpful to the conduct of corporate affairs or expedient for the attainment of corporate purposes. Except as explicitly permitted by statute, a board may not abdicate its authority by delegation of its powers of management and exclusive control of the business and affairs of the corporation. Moreover, members of the association cannot control the discretion of the directors in the exercise of the authority vested in them by their office. It is the directors, and not the members, who are best able to evaluate the numerous and often complex factors which must be considered in determining whether a particular action or decision serves the best interests of the corporation.

"BUSINESS JUDGMENT RULE"
Protecting directors by acting prudently and with ordinary care and inquiry complying with Corporations Code § 7231.

Thus, a board of directors and individual directors should approach their decision-making with the intent of complying with all aspects of the rule. In this regard, you are not expected to know with expertise all the particulars about the problems that come before you for decision. However, what the law does encourage and require is that, in acting prudently, directors retain the expertise that they do not have. This means, get help when you need it. A director has a right to rely on information, opinions, reports, or statements of employees of the association (whom the director believes to be reliable and competent), counsel, independent accountants, other consultants, and committees on which the director does not serve, as long as the director acts in good faith and makes reasonable inquiry when the facts indicate that an inquiry is needed. Corporations Code § 7231(b).

You should attempt to collect the necessary information you need to for your decision, you should make whatever reasonable inquiry is necessary, you should retain experts and consultants to assist you in understanding the issues, and then you should deliberate together, much like a jury, and then each individual director is expected to exercise his or her independent judgment when it is time to vote for the decision that you believe to be in the best interests of the association.

Although directors are protected by the business judgment rule, there are a couple exceptions to the rule. First, if the director delegates too much of his or her duties, they can lose the protection. Although it is true that a director may lawfully delegate corporate management to any person, management committee or property manager (see Corporations Code § 7210), realize that the ultimate responsibility for management of the
association rests with the board. Therefore, a director who continually misses meetings or
falls asleep during them, even if there are others managing the association's affairs, is not
acting in a reasonable manner and may not be protected by the business judgment rule.

Second, some directors in seeking election to the board, and others after they are
elected, represent that they have special expertise and knowledge that allows them to
make a better decision than others. This is okay, but remember, if you hold yourself out as
having such special knowledge BEWARE that you may be held to a higher standard of
care based on those representations.
FIVE TIPS FOR PREVENTING CORPORATE LIABILITY FOR YOUR DECISION-MAKING

(1) **Do Not Vote on a Matter When You Believe That It Possibly Involves a Conflict of Interest For You.** This is a simple rule if you ignore the issue of whether there is an "actual" conflict and instead focus on whether there is a perceived conflict of interest. Put yourself in someone else's shoes looking at your situation and position. If a matter comes before the board which you believe presents an apparent conflict of interest, then you should abstain from the vote and have your abstention noted in the record. Regardless of whether you vote or not, you should disclose the apparent conflict, honestly and completely, before the vote is taken.

(2) **Know and Follow the Rules and Laws Governing Your Association.** Learn what they say about your rights and responsibilities. Consult with legal counsel to understand the Davis-Stirling Common Interest Development Act and other laws that affect your association. Consult with your property manager about the management of your association. If you don't understand what is being said, how can you act in good faith and in compliance with the Prudent Business Judgment Rule and in the best interests of your association.

(3) **Consult and Rely on Experts.** Being a director does not require you to know everything in trying to make the right decisions for your association. You have a right to reasonably rely on experts who can help you out. The duty of inquiry and the right to rely on experts are part of the Prudent Business Judgment Rule. You are not obligated to accept the expert's advice. If you reject the expert's advice for valid reasons you will still be protected by the Prudent Business Judgment Rule. However, if you should not ignore expert advice or fail to seek it when you need it.

(4) **Maintain Adequate Directors' and Officers' Liability Insurance.** This type of insurance policy is sometimes called a D & O policy or an "errors and omissions" policy. It is different from your homeowner's insurance and the association's commercial liability insurance. Beyond making sure that the association has it and that it is properly maintained, get a copy of the policy and read it. You should know its terms. Know what is covered and what is not. Learn what expenses are covered. If you don't understand, consult someone who can answer your questions.

(5) **Be Attentive To Corporate Matters.** Directors who fail to participate in the meetings, who consistently miss meetings, and who do not pay attention to business, are not acting prudently. The Prudent Business Judgment Rule does not afford protection to
directors who are inattentive to the association's corporate affairs.

(5) Ensure That All Statutory Duties Imposed On the Association Are Complied With.