How Can Board Members Fulfill Their Fiduciary Duty?

Jan A. Kopczynski, Esq.

> "Fiduciary Duty: A duty to act for someone else's benefit, while subordinating one's personal interest to that of another person. It is the highest standard of duty implied by law (e.g., trustee, guardian)."

Most board members of community associations understand that they owe their members a "fiduciary duty." But what does that term mean, and how can board members satisfy this important legal obligation? This article explains.

For many years now, it has been well established that corporations – including nonprofits such as homeowners associations – have a fiduciary relationship with their members. But as we know, a homeowners association is not an actual person, and therefore it must act through its board of directors just as publicly traded companies do. As such, California law requires that *individual* board members owe their members a special duty to ensure that the affairs of the corporation are managed in the best interest of the members. Another aspect of this duty is that directors must avoid any conflicts of interest; i.e., they cannot make decisions that enrich themselves at the expense of the homeowners they represent. The failure of a board of directors to adhere to this heightened standard of care and loyalty can, and often does, result in serious liability to the corporation for failing to comply with this duty.

But how does this fiduciary concept play itself out in real world? For example, as of 2013, boards of directors have an obligation – a legal duty – to disclose to association members that a lawsuit may be filed against the association's builder for construction defects. Such notice must be provided to members, and a membership meeting must occur, no later than thirty days prior to filing of the claim (absent an emergency). *(See* Civil Code section 6150.) Failure to do so would be a breach of the board's duty.

Let's consider another scenario: Does a homeowners association have a fiduciary duty to notify its members that it has filed a claim against an ordinary vendor for breaching its contract with the association? Given the answer to the first question above, one might believe the answer is yes. As it turns out, this question was squarely addressed in 2003 by the Court of Appeal in a case known as *Ostayan v. Nordhoff Townhomes Homeowners Assn.*, 110 Cal. App. 4th 120 (July 2003).

The circumstances that gave rise to that case took place in 1997 when the plaintiff, Mr. Ostayan, purchased an uninhabitable condominium for the sum of $25,000 in the North Hills of Los Angeles. The condominium had previously been damaged by the 1994 Northridge earthquake. As a result of his purchase, he became a dues-paying member of the Nordhoff Townhomes Association.

During the period Mr. Ostayan owned his condominium, the association was involved in a dispute with its insurance carrier over coverage arising out of the 1994 earthquake. The dispute with the carrier was often discussed by the association's board of directors at their meetings. In fact, the association had sent its members, including Mr. Ostayan, three written notices about the insurance dispute.

Negotiations with the insurance carrier ultimately broke down, and the association filed a bad-faith lawsuit against the carrier. The problem was that the association did not inform its members of the litigation until a week *after* Mr. Ostayan had sold his unit to a third party for $53,000. As it turned out, in 2002 the association ended up settling its lawsuit against its insurance carrier for $20 million, and each unit owner received $180,000 of the settlement. But because Mr. Ostayan had sold his unit by the time of the settlement, he did not receive any of the settlement proceeds; he was no longer an owner of the condominium.

Believing he was entitled to some of the settlement funds, he filed suit against the association, alleging breach of fiduciary duty, based on the theory that the association owed him a duty of notification with respect to the association's claim against its insurer. The implication of Mr. Ostayan’s lawsuit was that, had the board timely informed him that it was suing the association's insurance carrier for failing to provide funds to repair the condominiums, Mr. Ostayan would have waited until the conclusion of the lawsuit before selling his unit. But without such notice, he sold his unit for a small gain, and in doing so he failed to reap the benefit of the $180,000-per-unit settlement with the insurance carrier. In effect, Mr. Ostayan lost out on an additional $127,000.

Notably, the trial court disagreed with Mr. Ostayan and found in favor of the association, ruling that the association did not owe him a duty of notification regarding the insurance claim. The Court of Appeal agreed and ruled that the association did ***not*** have a fiduciary duty to notify Mr. Ostayan (or its others members) that it had filed a bad-faith lawsuit against its insurer where the governing statutes and the association's governing documents did not require such notification. The court ruled that filing the action was within the scope of the association's inherent authority. And even if the association had such a duty of notification, it satisfied that duty in this case by disclosing its dispute with the insurer in three separate written communications to its members, which included plaintiff at the time.

From this one case, board members can learn several valuable points:

First, board members must remember that they are fiduciaries, and therefore they must act carefully and in the best interest of the members of the association. This is a heightened standard of care that carries with it severe penalties if breached. In short, directors must act with due diligence, exercise sound business judgment, and place the interests of the members above their own (i.e., no self-dealing).

Second, in exercising its fiduciary duties, boards of directors are required to follow the association's declaration of covenants, conditions, and restrictions (CC&Rs). That is the key document that contains "the restrictions on the use or enjoyment of any portion of the common interest development that are intended to be enforceable equitable servitudes." (See Civil Code section 4250.) Boards must also follow the statutory duties that are set forth in the Davis-Stirling Common Interest Development Act (Civil Code section 4000 *et seq.*) and the Nonprofit Mutual Benefit Corporation Law (Corp. Code section 7110 *et seq.*). These laws are lengthy, complex, and require careful analysis. Boards should not hesitate to engage outside legal counsel to help navigate the various legal requirements.

Third, despite the heightened standard of care, a board member's fiduciary duties are not unlimited. Indeed, the *Ostayan* opinion is another in a growing line of appellate opinions that affirms the power of a community-association board to exercise discretion and sound business judgment in its affairs with its members and third parties. And if the board does its due diligence and acts carefully, the board will be protected from frivolous claims. (*See Lambden v. La Jolla Shores Homeowners Assn.*, 21 Cal. 4th 249 (1999) and *Nahrstedt v. Lakeside Village Condominium Assn.*, 8 Cal. 4th 361 (1994).)

Keeping the above principles in mind, the safest course of action is to keep the homeowners informed about important association activities as required under the association's CC&Rs and the statutes in effect at the time. Doing so provides the board with powerful evidence in a later dispute with a member that the board met its fiduciary responsibilities.

Jan A. Kopczynski is the founder of THE ROCK LAW FIRM in San Francisco. He has been representing California homeowners associations for nineteen years.