STANDARDS OF DUTY & LIABILITY FOR COMMUNITY ASSOCIATION OFFICERS & DIRECTORS

33rd Annual Advanced Real Estate Law Course
July 7, 2011

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STANDARDS OF CARE
DUTIES & LIABILITIES FOR
COMMUNITY ASSOCIATION OFFICERS & DIRECTORS

I. SCOPE

The scope of this paper is not to present a complete history of the law as it relates to the duties and liabilities of directors of community associations, but to analyze the current state of the law and offer suggestions on how to identify areas of the duties and potential liability of directors and officers of community associations. The areas to be discussed apply to directors and officers of associations for single family homes, condominiums, and townhomes, unless otherwise indicated.

The primary function of community associations is typically to preserve community building standards and property values through the establishment and enforcement of restrictive covenants. Secondary to that function, community associations collect assessments which fund the enforcement of the restrictive covenants and maintenance of the common areas. Although community associations collect revenue in an adequate amount to provide necessary funding, their essential nature remains a non-profit, volunteer organization.

The entity choice for most community association is a non-profit corporation and in the case of a condominium an incorporated entity is required for all condominiums established after January 1, 1994.

The presence of community associations can be seen in almost any urban or suburban community in the United States. Predictably, as the number of community associations increases, so do the number of legal challenges. The difficulty, particularly in Texas, lies in identifying the proper standard by which to examine the actions (or inactions) of the directors and officers serving on community associations' boards. It is often difficult to determine what an officers and director's obligations and duties are, and what actions or inactions may subject that officer or director to liability. For members of a community association, and especially for members serving as directors or officers on the association's board of directors, the issue of personal liability arising from service in the community association is of particular concern.

This paper discusses the standard of care that is established for board members and officers and the immunity from liability that is obtained as a result of meeting that standard of care. The immunity comes from federal and state laws which establish certain thresholds that must be achieved for the standard of care to be met.

Generally, a director or an officer is not liable to a corporation or any other person for actions taken or omissions made by the director or officer in the person's representative capacity unless the conduct was not exercised in good faith, with ordinary care and in a manner the director or officer reasonably believed to be in the best interest of the corporation. Additionally, in most cases directors and officers are entitled to rely on their own business judgment so long as this judgment does not overstep bounds of reason, common sense, or fairness or contravene public policy or laws.

The Community Associations Institute ("CAI") estimates that there are approximately 62 million Americans, living in 24.6 million housing units, within over 309,600 community associations.[1] More than 1.75 million volunteers serve on community association boards, with tens of thousands more serving as committee members. Combined, the estimated value of these community association volunteer governance services is about $450 million. According to one estimate, about 26 percent of the eligible U.S. population volunteers at some point during a year; community association leaders volunteer continuously during a year, and a large percentage of them for many years.[2] In 2010, community association boards supervised the collection of more than $41.5 billion in annual assessments and maintained investment accounts of another $36-$37 billion for the long-term maintenance and replacement of commonly held property.[3]

Nearly one out of every six Americans lives in community associations nationwide.[4] With more than fifty percent of new development in large metropolitan areas using a community association format, CAI forecasts continued growth of 6,000 to 8,000 additional community associations each year. As this type of community continues to increase, the role of the association, and its officers and directors, has evolved and expanded by taking on much broader functions.[5] Associations now operate not only as businesses, but also have taken on responsibility for building social infrastructure and a sense of community among their residents.

Predictably, as the number of associations increases, so do the number of legal challenges. The difficulty, particularly in Texas, lies in identifying the proper standard by which to examine the actions (or inactions) of the various directors and officers serving on the association's boards. It is often difficult to determine what a director's obligations and duties are, and what actions or inactions may subject that director to liability.

II. APPLICABLE LAW

Statutes that apply to directors of community associations include but are not limited to the following:

- Texas Property Code;
- Texas Business Organizations Code;
- Charitable Immunity and Liability Act of 1987, Tex.Civ.Prac. & Rem. Code §84;
- The Volunteer Protection Act of 1997; 42 USC 14501;
- Texas Finance Code;
- Telecommunications Act if 1996;
- Fair Housing Amendments Act;
- Americans with Disabilities Act

Additionally, community associations may generally be subject to employment laws, local ordinances, and environmental laws.

In addition to the statutory law to be applied to community associations, each community association has its own body of authority to enforce from its Dedicatory Instruments. Such instruments may include some or all of the following:

- Declaration of Covenants, Conditions and Restrictions (also referred to as "Deed Restrictions")
- Certificate of Formation (formerly referred to as Articles of Incorporation) of the Community Association
- By-Laws adopted by the Community Association
- Architectural/Builder Guidelines
- Rules & Regulations promulgated by the Community Association

III. BUSINESS ORGANIZATIONS CODE - CHAPTER 22

The Texas Non-Profit Corporation Act has been codified at Chapter 22 of the Business Organizations Code. Chapter 22 of the Business Organizations Code sets forth the standard for director's liability, in pertinent part as follows:

Section 22.221. General Standards for Directors

A. A director shall discharge the director's duties, including duties as a committee member, in good faith, with ordinary care, and in a manner the director reasonably believes to be in the best interest of the corporation.

B. A director is not liable to the corporation, a member, or another person for an action taken or not taken as a director if the director acted in compliance with this section. A person seeking to establish liability of a director must prove that the director did not act:

(1) in good faith;

(2) with ordinary care; and

(3) in a manner the director reasonably believed to be in the best interest of the corporation.

Section 22.225. Officer Liability

(a) An officer is not liable to the corporation or any other person for an action taken or omission made by the officer in the person's capacity as an officer unless the officer's conduct was not exercised:

(1) in good faith;
(2) with ordinary care; and

(3) in a manner the officer reasonably believes to be in the best interest of the corporation.

(b) This section shall not affect the liability of the corporation for an act or omission of the officer.

Section 22.223. Not A Trustee

A director is not deemed to have the duties of a trustee of a trust with respect to the corporation or with respect to any property held or administered by the corporation, including property that may be subject to restrictions imposed by the donor or transferor of the property.

Section 3.102. Rights Of Governing Persons In Certain Cases

(a) In discharging a duty or exercising a power, a governing person, including a governing person who is a member of a committee, may, in good faith and with ordinary care, rely on information, opinions, reports, or statements, including financial statements and other financial data, concerning a domestic entity or another person and prepared or presented by:

(1) an officer or employee of the entity;

(2) legal counsel;

(3) a certified public accountant;

(4) an investment banker;

(5) a person who the governing person reasonably believes possesses professional expertise in the matter; or

(6) a committee of the governing authority of which the governing person is not a member.

(b) A governing person may not in good faith rely on the information described by Subsection (a) if the governing person has knowledge of a matter that makes the reliance unwarranted.

The State Bar Committee published an official comment in 1993 to clarify Article 2.28 of the Texas Nonprofit Corporation Act which although the statute has been codified in the Business Organizations Code, the comment is still instructive. In pertinent part, the comment states:

1. General Standards of Conduct

New Article 2.28 sets forth the general standards of conduct for directors of nonprofit corporations. It is intended to reject any notion that directors of nonprofit corporation are to be judged by the standards imposed upon trustees of trusts. Article 2.28 preempts other rules

related to a trustee standard even though the corporation, as distinguished from its director, may hold or be deemed to hold property in trust or subject to restrictions.

2. Standard of Conduct

The general duty of directors of nonprofit corporations is set forth in the mandate of Article 2.28 that directors act in good faith, with the care of an ordinarily prudent person in a like position would exercise under similar circumstances, in a manner they reasonably believe to be in the best interests of the corporation. Development of standards in this area are left to judicial resolution.

3. Good Faith

A precondition to a director discharging his or her duties is that the director act in good faith. While this is a subjective requirement, a court will look to objective facts and circumstances to determine whether the good faith requirement is met. A court generally will look to the director's state of mind to see if it evidenced honesty and faithfulness to the director's duties and obligations, or whether there was an intent to take advantage of the corporation.

4. Duty of Care

Article 2.28 requires that a director, in discharging his or her duties, act with the care of an ordinarily prudent person in a like position under similar circumstances. This familiar language allows directors of nonprofit corporations to exercise their judgment with due regard to the nature, operations, finances, and objectives of their organizations. The "ordinarily prudent person" concept is used in various contexts. In the context of nonprofit corporations it applies to directors who balance potential risks and rewards in exercising their duties as directors. It is intended to protect directors who innovate and take informed risks to carry out the corporate goals and objectives. The directors need not be right, but they must act with common sense and informed judgment. The duty of care recognizes that directors are not guarantors of the success of investments, activities, programs or grants. It allows leeway and discretion in exercising judgment.

Directors must spend enough time on the corporation's affairs to be reasonably acquainted with matters demanding their attention. In appropriate circumstances the duty of care requires reasonable inquiry. The concept of "in a like position" takes into account the fact that directors of nonprofit and business corporations are not in like positions, but have different goals, objectives and resources. The concept of "under similar circumstances" relates not only to the circumstances of the corporation but to the special background, qualifications, and management experience of the individual director and the role the director plays in the corporation. A court should not be harsh in second-guessing directors who in good faith make a judgment that proves incorrect.

5. Reasonable Belief that Action is in the Best Interests of the Corporation

The requirement that the director act in a manner the director reasonably believes is in the best interests of the corporation is both objective and subjective. It is objective in that the director must reasonably believe the action is in the best interests of the corporation. It is

subjective in that the director must in fact believe the action is in the best interests of the corporation. As with the good faith requirement, a court is likely to look to objective facts to determine whether a director's state of mind appears unreasonable and whether the director really believed that the action was in the best interests of the corporation.

6. Reliance

So long as a director does not have knowledge that would make reliance unwarranted, a director may rely on information, opinions, reports, and statements prepared and presented by the individuals and committees specified in Article 2.28, Section B. . . with the one exception that a director may only rely on information from individuals or committees who the director believes to be competent.

IV. **CHARITABLE IMMUNITY AND LIABILITY ACT OF 1987**

The Charitable Immunity and Liability Act of 1987 appears in Chapter 84 of the Texas Civil Practice and Remedies Code.[6] It should be noted that this act protects directors from challenges asserted by third parties. The Act specifically does not provide any protection involving suits by members of a community association against a community association's volunteers. Pursuant to §84.003, the definition of a charitable organization includes a homeowners association.[7] A volunteer is a person rendering services for or on behalf of a charitable organization who does not receive compensation in excess of reimbursement for expenses incurred.[8] The term includes a person serving as a director, officer, trustee, or direct service volunteer, including a volunteer health care provider.[9] Good faith is defined as the honest, conscientious pursuit of activities and purposes that the organization is organized and operated to provide.[10]

The Charitable Immunity and Liability Act of 1987 generally deems a charitable organization's officers and volunteers immune from civil liability for actions taken in the scope of official or volunteer duties.[11] The act was adopted to reduce the liability exposure and insurance costs of charitable organizations in order to encourage volunteer services and maximize the resources devoted to delivering these services.[12]

Section 84.004 sets out the volunteer immunity, in pertinent part, as follows: a volunteer who is serving as an officer, director, or trustee of a charitable organization in immune from civil liability for any act or omission resulting in death, damage, or injury if the volunteer was acting in the course and scope of his duties or functions as an officer, director, or trustee within the organization.[13] The immunity runs only to the volunteer and does not apply to the liability of the organization for acts or omission of volunteers.[14]

Finally, board members and officers are entitled to rely on their own business judgment so long as that judgment does not overstep the bounds of reason, common sense, fairness, or contravene public policy or laws. This common-law protection also allows the volunteer directors and officers to rely on advice obtained from persons knowledgeable about the issue being considered. For example, a community association board may rely on its legal counsel so that its actions would be considered to have been taken in good faith.

Sections 84.005 and 84.006 set monetary caps on liability as follows:

§84.005 Employee Liability

Except as provided in Section 84.007 of this Act, in any civil action brought against an employee of a non-hospital charitable organization for damages based on an act or omission by the person in the course and scope of the persons' employment, the liability of the employee is limited to money damages in a maximum amount of $500,000 for each person and $1,000,000 for each single occurrence of bodily injury or death and $100,000 for each single occurrence for injury to or destruction of property.

§84.006 Organization Liability

Except as provided in Section 84.007 of this Act, in any civil action brought against a non-hospital charitable organization for damages based on an act or omission by the organization or its employees or volunteers, the liability of the organization is limited to money damages in a maximum amount of $500,000 for each person and $1,000,000 for each single occurrence of bodily injury or death and $100,000 for each single occurrence for injury to or destruction of property.

Section 84.007 sets forth the limitations of applicability of the act in pertinent part as follows:

(a) This chapter does not apply to an act or omission that is intentional, willfully or wantonly negligent, or done with conscious indifference or reckless disregard for the safety of others.

(b) This chapter does not limit or modify the duties or liabilities of a member of the board of directors or an officer to the organization or its members and shareholders.

(c) This chapter does not limit the liability of an organization or its employees or volunteers if the organization was formed substantially to limit its liability under this chapter.

(g) Sections 84.005 and 84.006 of this Act do not apply to any charitable organization that does not have liability insurance coverage in effect on any act or omission to which this chapter applies. The coverage shall apply to the acts or omission of the organization and its employees and volunteers and be in the amount of at least $500,000 for each person and $1,000,000 for each single occurrence for death or bodily injury and $100,000 for each single occurrence for injury to or destruction of property.

As the Texas Attorney General explains, the liability of employees and of the organization itself is limited to money damages in a maximum amount set out in the statute.[15] These limitations on liability are available only to a charitable organization that carry liability insurance in the amounts required by the statute.[16]

While the *Cox* case involved a personal injury claim against an unincorporated charitable association prior to the inception of the act, the court offered the following helpful explanation:

> In cases, however, in which the [Charitable Immunity and Liability] Act is applicable, charitable organizations, as specifically defined by the Act, can effectively insulate themselves from liability by maintaining the statutorily required levels of insurance. Of course, protection is also afforded by the simple act of incorporation.[17]

V. VOLUNTEER PROTECTION ACT OF 1997

The federal government, in an effort to encourage volunteerism in the United States and to limit the potential liability of the volunteer, set forth regulations protecting volunteers such as those serving on their neighborhood community association boards. The Volunteer Protection Act of 1997[18] provides that the need for clarifying and limiting the liability risk assumed by volunteers is an appropriate subject for federal legislation because of the national scope of the problems created by the legitimate fears of volunteers about frivolous, arbitrary, or capricious lawsuits.[19] A community association, as a nonprofit volunteer corporation, and individuals serving as board members, as volunteers are subject to the rules and regulations promulgated pursuant the Volunteer Protection Act of 1997 (the "Federal Act").

A legislative history of the Federal Act is found in *Armendarez v. Glendale Youth Center, Inc.*, and cites the House Committee report, that: although every state now has a law pertaining specifically to legal liability of at least some types of volunteers, many volunteers remain fully liable for some actions. Only about half of the states protect volunteers other than officers and directors. Moreover, every volunteer protection statute has exceptions. As a result, state volunteer protection statutes are patchwork and inconsistent. This inconsistency hinders national organizations from accurately advising their local chapters on volunteer liability and risk management guidelines.[20]

In light of this legislative history, the *Armendarez* court found that Congress intended the Federal Act to cover *all* civil lawsuits including both federal and state law except those suits involving certain types of egregious misconduct.

Since community associations are typically nonprofit volunteer corporations, and their directors are volunteers, directors and officers of community associations are subject to the rules and regulations promulgated pursuant the Federal Act.

The Federal Act provides that volunteers of nonprofit organizations are not liable for harm caused by an act or omission of the volunteer on behalf of the organization or entity if the volunteer was acting within the scope of the volunteer's responsibilities in the nonprofit organization or governmental entity at the time of the act or omission, the harm was not caused by willful or criminal misconduct, gross negligence, reckless misconduct, or a conscious, flagrant indifference to the rights or safety of the individual harmed by the volunteer.

However, the Federal Act does not protect volunteers against suits brought by the entities or organizations they serve.[21] Moreover, the Federal Act does not affect any actions taken

against the organization or entity with respect to harm caused to others. Some states limit volunteer liability by (1) requiring a non-profit organization or governmental entity to adhere to risk management procedures, including mandatory volunteer training, (2) making the organization or entity liable for the acts or omissions of its volunteers to the same extent as an employer is liable for the acts or omissions of its employees, (3) limiting liability in civil actions brought by a State or local government officer, or (4) only permitting liability limitation if the organization or entity provides a financially secure source of recovery for individuals who suffer harm as a result of actions taken by a volunteer on behalf of the organization or entity (i.e. insurance, risk pooling mechanism, equivalent assets, etc.). If state laws limit volunteer liability as listed above, the state laws will not be construed as inconsistent with the Federal Act.[22]

The Federal Act also protects volunteers from punitive damages if the volunteer was acting in the scope of the volunteer's responsibilities.[23] To obtain punitive damages against a volunteer, it must be shown by clear and convincing evidence that the volunteer's action constituted willful or criminal misconduct or was a conscious, flagrant indifference to the rights or safety of the individual harmed.[24] The Federal Act does not protect conduct that is a crime of violence, an act of terrorism, a hate crime, nor does it protect actions that involve a sexual offense or violate state or federal civil rights law. Moreover, the Federal Act does not prevent a volunteer from being held liable for his/her actions if the volunteer was under the influence of alcohol or drugs.

VI. TEXAS PROPERTY CODE

The Property Code affords some protection to directors acting to enforce restrictive covenants, in pertinent part, as follows:

§202.004. Enforcement Of Restrictive Covenants

> (a) An exercise of discretionary authority by a property owners' association or other representative designated by an owner of real property concerning a restrictive covenant is presumed reasonable unless the court determines by a preponderance of the evidence that the exercise of discretionary authority was arbitrary, capricious, or discriminatory. [25]

The *Herbert* court cited §202.004(a) in its analysis of a request for declaratory judgment for construction of restrictive covenants.[26] The Polly Ranch Homeowners Association filed for declaratory judgment requesting construction of its subdivision restrictions. Homeowners filed counterclaims for declaratory judgment claiming they could build two single family homes on a single platted lot that had been subdivided into two lots. The trial court ruled in favor of the association. The appellate court held that the restrictions did not preclude the homeowners from building two single-family houses on a single platted lot that had been subdivided as long as setback requirements were met.

The homeowners contended that the language of the restrictions did not expressly prohibit two homes on one lot, and therefore their plans complied with the restrictions. The Association countered that it was the drafter's intent to limit each platted lot to one single-family residence. The court reasoned that absent specific language prohibiting same, the homeowner should be allowed to place an additional home on the new lot created by subdividing their lot.[27]

The court heard the testimony of one of the developers of Polly Ranch who had drafted the restrictions. The developer testified that it was his intent that only one residence would be built on one lot as originally platted.

Both sides agreed that the restrictions were not ambiguous. Absent an ambiguity, the testimony of the developer was parol evidence and not admissible.[28] The court considered the plain language of the restrictions to conclude that more than one house could be placed on each originally platted lot.

The *Herbert* court acknowledged the presumption of reasonableness as set out in the statute, but offered no helpful analysis of what reasonableness actually is.[29] It is the lack of reported cases with helpful guidance from the courts, that creates a gap in the analysis of liability for directors actions. There is however, adequate case law defining the terms set out in the statute.

VII. DEFINITION OF TERMS

A. Arbitrary

It is well established in Texas that the word "arbitrary" means the failure to exercise an honest judgment.[30] The Goodrum case was a suit to recover certain sums alleged to have been withheld by the defendants as penalties, and for damages, growing out of two contracts between the parties for construction of a stretch of highway.[31] The court explained that the term "arbitrary" has been expressly held to contemplate bad faith.[32]

The *Goodrum* court relied on the standard dictionary definition of arbitrary as "fixed or done capriciously or at pleasure; without adequate determining principle; not founded in the nature of things; nonrational; not done or acting according to reason or judgment; depending on the will alone; absolutely in power; capriciously; tyrannical; despotic."[33]

The courts have continued to define arbitrary as fixed or done capriciously or at pleasure; not founded in the nature of things; non-rational; not done or acting according to reason or judgment; depending on the will alone; tyrannical; despotic.[34] The *Webb* court further defined arbitrary as being bound by no law, harsh and unforebearing.[35]

The *Webb* court offered the following definitions:

> These terms (arbitrary and capricious) must mean willful and unreasoning action, action without consideration and in disregard of the facts and circumstances of the case. Action is not arbitrary or capricious when exercised honestly and upon due consideration, where there is room for two opinions, however much it may be believed that an erroneous conclusion was reached.[36]

The *Mitchell's* court explained that a decision is arbitrary when it is made without fair, solid and substantial cause or reason.[37] In an action by a lessee against a lessor for breach of contract wherein the lessor agreed not to unreasonably withhold his consent to sublease the premises, the court examined the meaning of arbitrary. The court held that arbitrary acts are capricious, despotic, tyrannical, bound by no law, and are performed without regard to principles. The court further held that although a decision is mistaken or wrong, it is not necessarily arbitrary.[38]

B. CAPRICIOUS

Notwithstanding the risk of presenting circular definitions, early cases often defined capricious as synonymous with arbitrary:

> In many respects the words arbitrary and capricious are synonymous. The word capricious means freakish, whimsical, fickle, changeable, unsteady, and arbitrary.[39]

The *Vilbig* case relied on the above definitions from the *Webb* court and held as follows:

> Action is not arbitrary or capricious when exercised honestly and upon due consideration, where there is room for two opinions, however much it may be believed that an erroneous conclusion was reached.[40]

The *Vilbig* case dealt with a change of plans arrived at during the course of a vast public housing project leading to the probability of excess land. The excess land issue was challenged as arbitrary and capricious by the grantors who were seeking rescission and cancellation of three deeds.[41] The court found no arbitrary or capricious action on the part of the developers.

In a condemnation case, the court instructed the jury that arbitrary and capricious action meant willful and unreasoning action, action without consideration, and in disregard of the facts and circumstances that existed at the time condemnation was decided upon, or within the foreseeable future.[42] The court held that an act is not arbitrary and capricious when exercised with due consideration, even if an erroneous conclusion was reached.[43]

C. DISCRIMINATORY

Black's Law Dictionary defines discriminatory as "a failure to treat all persons equally where no reasonable distinction can be found between those favored and those not favored." Typically, the question of discrimination is brought before the court as a constitutional claim. The *Miller* court, in addressing a case of discriminatory prosecution, stated that to prevail on a claim of discrimination, the plaintiff must prove that they have been singled out for prosecution while others similarly situated and committing the same acts have not.[44]

A claim of discrimination has an element of bad faith, in that it rests upon such impermissible grounds as race, religion, or the desire to prevent the exercise of constitutional rights.[45]

The *Zent* court found discriminatory action by owners in attempting to remove restrictive covenants as to certain lots only via an amendment to the restrictive covenants.[46] Owners of five residential lots restricted to single-family residences, brought suit to enjoin owners of adjacent lots from erecting duplex residences on their property. The duplex owners attempted to modify the restrictions as to their lots only so as to permit construction of the duplex dwelling units on each of their lots. The court found that such an amendment was discriminatory because it did not seek to revoke or amend the restrictions as to all of the properties subject to the restrictions.[47]

The court permanently enjoined the building of the duplex dwelling units as a violation of the restrictive covenants. The court reasoned as follows:

> The language employed by the subdividers of Section Four shows an intent to establish a general plan applicable to the whole section. A rule that would permit the majority of the lot owners to alter or revoke the restrictions as to a few lots only, and to continue the covenants as to all other property in the section, would invite foreseeable mischiefs not within the original purposes of the subdividers. The most obvious of such mischiefs to result are uncertainties and possible discriminations.[48]

The most common discrimination complaints are brought by disgruntled homeowners who believe they are being singled out with regard to enforcement of deed restrictions. The challenges are typically based on a protected status and complaints of unequal treatment. Once a homeowner believes they are being discriminated against, they will usually look for similar violations that do not appear to have received the same enforcement efforts. It is imperative that a community association treat all equal violations within the subdivision in the same manner; with the same notices, and with the same follow-up actions.

VIII. QUALITY OF THE DECISION

Decisions made by directors are often subject to the scrutiny and criticism of those affected by those decisions. Typically, such challenges examine the "quality of the decision" made by the director in an effort to impose personal liability on the director for what are perceived as bad decisions. Without some protection in the courts, it would be almost impossible to get directors to serve as volunteers on POA boards. Unfortunately, there is very little case law to rely on as to the standard for directors of non-profit corporations. The Supreme Court of Texas has stated that the similarities between homeowners' association and corporations has led to the conclusion that a homeowners' association is a separate legal entity from its unit owners, just as a corporation is distinct from its shareholders.[49] A review of case law identifies two standards typically applied by the courts, the "Business Judgment Rule" and the "Reasonableness" standard.

A. BUSINESS JUDGMENT RULE

In Texas, corporate directors (of for-profit corporations) are afforded some protection from liability for their acts as directors in what is known as the "Business Judgment Rule."[50] In *Pace*, two shareholders filed a derivative cause of action purportedly on behalf of the corporation, and the corporation filed a counterclaim for attorney fees.

The plaintiff, Pace, made a demand on the board of directors through three letters.[51] He invoked the Texas Business Corporation Act, set forth his complaints, named the officers and directors that allegedly harmed the corporation, requested that those individuals be fired, and requested that the board sue the officers for mismanagement. The board discussed Pace's claims, and the outside directors decided that litigation was not in the corporation's best interest.

To show that the decision of the directors was governed by something other than sound business judgment, Pace had to prove that the board's refusal to act was characterized by an ultra vires, fraudulent, and injurious practice, and abuse of power, and an oppression on the part of the company or its controlling agency, clearly subversive of the rights of the minority, or of a shareholder, and which, without such interference, would leave the latter remediless.[52] The court found that the board meeting to discuss the demand was sufficient to entitle the board to invoke the protection of the Business Judgment Rule.

The court explained that a board may invoke the business judgment rule's protection only if the directors are informed before making a decision, "of all material information reasonably available to them."[53] In assessing whether the board was informed, pertinent matters include the information considered, the use of experts or consultants, the notice given to the board, and its independence.[54]

The *Bavel* case confirmed such protection when it held that although officers and directors must act fairly and in the best interest of the corporation, a director is not liable for his conduct if it falls within the protection of the Business Judgment Rule.[55] Bavel brought a shareholder's derivative suit against Oasis Design for fraud, breach of contract, and breach of fiduciary duty related to a proposed merger.

The court explained that under the Business Judgment Rule, conduct that is merely unwise, inexpedient, or imprudent will not sustain suit against management of a corporation by its shareholders.[56] The jury was instructed that a director will not be held liable for an honest mistake of judgment if he acted with due care, in good faith, and in furtherance of a rational business purpose.[57]

Due to a lack of case law establishing the standard for directors of nonprofit corporations, one must look to the law of for-profit corporations for guidance on what acts may be protected by the Business Judgment Rule. The *Gearhart* court when construing the Business Judgment Rule under Texas law provided the following analysis:

> Unquestionably, under Texas law, a director as a fiduciary must exercise his unbiased or honest business judgment in pursuit of corporate interests. . . In other jurisdictions, a corporate director who acts in good faith and without corrupt motive will not be held liable for mistakes of business judgment that damage corporate interests. This principal is known as the business judgment rule and it is a defense to accusations of breach of the duty of care.[58] Few Texas cases discuss the issues of a director's standard of care, negligent mismanagement, and business judgment.[59]
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> Texas courts to this day will not impose liability upon a noninterested corporate director unless the challenged action is ultra vires or is tainted by fraud. Such is the business judgment rule in Texas.[60]

Section 22.223 of the Business Organizations Code provides that a director of a [nonprofit] corporation is not considered to have the duties of a trustee of a trust with respect to

the corporation or with respect to property held or administered by the corporation, including property subject to restrictions imposed by the donor or transferor of the property. However, as to condominiums restricted after January 1, 1994, Chapter 82 of the Texas Property Code provides in pertinent part as follows:

> §82.103. Board Members & Officers
>
> (a) Except as provided by the declaration, bylaws, or this chapter, the board shall act in all instances on behalf of the association if in the good-faith judgment of the board the action is reasonable. Each officer or member of the board is liable as a fiduciary of the unit owners for the officer's or member's acts or omission. All acts of the association must be by and through the board unless otherwise provided by the declaration or bylaws or by law.

The *Harris v. Spires* court reasoned as follows:

> The property Code recognizes that each officer or member of a condominium board is liable as a fiduciary of the unit owners for the officers' or members' acts or omissions. The officers and members must fulfill the duties owed to the unit owners with reasonable care, diligence, good faith, and judgment. A fiduciary duty may also arise by contract or in the context of an informal moral, social, domestic, or personal relationship in which one person trusts or relies on another.[61]

It should be noted that the Spires Condominium was restricted on July 6, 1983, and the court offered no explanation as to why it cited §82.103 (which applies only to condominiums restricted after January 1, 1994) in its opinion.

The *Bavel* court instructed the jury that although officers and directors must act fairly and in the best interest of the corporation, a director is not liable for his conduct if it falls within the protection of the business judgment rule.[62]

Taken from another tact, the courts have, over time, created a list of director actions which are *not* protected by the Business Judgment Rule. The following laundry list appeared in an unpublished case:

> . . . something beyond unsound "business judgment" has governed the board of directors' refusal to act. Under the business judgment rule, a shareholder cannot institute a derivative suit on the corporation's behalf by merely showing that the decision of the board of directors not to act was unwise, inexpedient, negligent or imprudent.
>
> To show that the board's decision was not governed by sound business judgment, [the shareholder] had to show that the board of directors' refusal to act was characterized by an ultra vires, fraudulent, and injurious practice, by an abuse of power, and by an oppression on the part of the company or its controlling agency clearly subversive of the rights of the minority, or of a shareholder, and which, without such interference, would leave the latter with no remedy.[63]

In *Lamden*, the California case proposed that the appropriate standard for volunteer directors of POA's is the Business Judgment Rule.[64] The California Supreme Court explained the application of the Business Judgment Rule as follows:

> . . . that rule of judicial deference to corporate decision making exists in one form or another in every American jurisdiction.

The common law business judgment rule has two components – one which immunizes (corporate) directors from personal liability if they act in accordance with its requirements, and another which insulates from court intervention those management decisions which are made by directors in good faith in what the directors believe is the organization's best interest.

A hallmark of the business judgment rule is that, when the rule's requirements are met, a court will not substitute its judgment for that of the corporation's board of directors.[65]

While the *Lamden* court declined to technically apply the Business Judgment Rule to the acts of the directors of the condominium owners' association, it did defer to the board's decision.[66] The *Lamden* court upheld the trial court's "deferential business judgment test."[67]

B. Reasonableness Standard

A "reasonableness" standard for reviewing the acts of directors does not afford the director the same level of deference by the courts. Without the protection of the Business Judgment Rule, the courts are able to re-examine the decisions made by a director by determining the "reasonableness" of those decisions. This standard has been examined by Texas courts in two different scenarios.

1. Condominium Association

First, when dealing with a condominium association, the courts have routinely applied the standard of reasonableness. The reasonableness of the directors' actions are measured in the context of the uniqueness of condominium living.[68] The *Pooser* court reasoned as follows:

> Condominium unit owners constitute a democratic subsociety, of necessity more restrictive in the use of condominium property than might be acceptable given traditional forms of property ownership. Therefore, each constituent must relinquish some degree of freedom of choice and agree to subordinate some of his traditional ownership rights when he elects this type of ownership experience.[69]

A condominium association is vested with considerable discretion in exerting managerial and administrative responsibilities. Absent evidence that the directors' actions were either arbitrary or capricious, the court found the actions of the board to be reasonable.[70]

In the *Gulf Shores Council of Co-Owners* case, a condominium owner challenged the council of co-owners' right to levy fees for renting outside of the co-owners' pool.[71] The court held that the rules of the council were not unreasonable and explained as follows:

> A condominium association has considerable discretion to determine the necessary expenses for the operation of the condominium project and to assess the owners' pro rata share of the common expenses. We apply a "reasonableness" standard when reviewing the action of a condominium association or its board of directors, recognizing they may not enforce arbitrary, capricious, or discriminatory rules. They can only assess services reasonably necessary to achieve the purpose of creating a uniform plan for the development and operation of the condominium project.[72]

Even in the application of the reasonableness standard there is a certain amount of "borrowing" of law from for-profit corporations. The Supreme Court of Texas has held that a co-owner in a condominium regime has no more control over operations than he would have as a stockholder in a corporation which owned and operated the project.[73]

2. Single Family Homes Association

Second, when addressing an association of individual homes (rather than condominiums) there are very few reported cases addressing the appropriate standard to review directors' actions. The *Frey* court reported that the test to be applied to rules proposed by the Board of Directors is one of reasonableness.[74] In *Frey* an owner challenged the POA's imposition of special transfer fees and user fees against lessors of lots within the subdivision. Both the trial court and the appellate court upheld the fees and reasoned as follows:

> Courts will not interfere with an association's right of internal management so long as the governing body does not substitute legislation for interpretation, overstep bounds of reason, common sense, or fairness, or contravene public policy or laws of the land in its interpretation and administration.[75]

The *Frey* case was ultimately appealed, and affirmed on procedural grounds which deleted the above helpful language.[76]

As was the case in the Business Judgment Rule, while not defining "reasonable," the courts have given some guidance as to what might be considered "unreasonable." Again "borrowing" from landlord tenant law the court defined what an "unreasonable" withholding of consent to sublease entailed.[77] The *Mitchell's* court relied on Webster's definition of unreasonable as: "not conformable to reason; irrational; also, not governed or influenced by reason. Beyond the bounds of reason or moderation; immoderate; exorbitant."[78] The court further reasoned that the term unreasonable conveys the same idea as irrational, foolish, unwise, absurd, silly, preposterous, senseless, and stupid. And finally the court stated that what is unreasonable is where, under the evidence presented, there is no room for differences of opinion among reasonable minds.[79]

IX. INTEGRITY OF PROCESS

With no reliable standard by which to measure a director's actions, the prudent approach for a director is to adhere strictly to the process established in the community association's dedicatory instruments. For example, to increase an annual maintenance assessment, the directors should strictly follow the procedures and limitations set forth in their documents. By

maintaining the integrity of the process, they reduce the scope of a challenge. As pointed out above, their decisions are somewhat protected by the Business Judgment Rule and/or the reasonableness standard. Their actions are best protected by adhering to the procedures set forth in their documents.

The courts have recognized that all of the community association's documents may be read together in examining an act by a director. In addition to the express provisions in the restrictive covenants, the community association is vested with the powers and purposes enumerated in its articles of incorporation and bylaws.[80] These powers and purposes necessarily modify the express provisions of the restrictive covenants. When a director acts within the power granted and for the purposes enumerated, the court will recognize the presumption of good faith created in §202.004 of the Property Code.[81]

The *Holleman* court upheld the actions of a board of directors attempting to enforce a restriction against parking overnight on driveways within the subdivision.[82] The court relied on a Florida case and reasoned as follows:

> If a rule is reasonable, the association can adopt it; if not, it cannot. It is not necessary that conduct be so offensive as to constitute a nuisance in order to justify regulation thereof.
>
> - - -
>
> In the present case the Board of Directors are authorized to make reasonable rules pertaining to the common area in the Subdivision. Certainly, the Association is not at liberty to adopt arbitrary or capricious rules bearing no relationship to the health, happiness, and enjoyment of life of the various unit owners.

The purposes for which the association was organized included providing for maintenance, preservation, and architectural control of the residential lots and the common area in the subdivision; promoting the health, safety, and welfare of the property owners in the subdivision; and exercising the powers granted by the Declaration of Covenants and Restrictions applicable to the subdivision. These powers include enforcement of the covenants and restrictions in the Declaration.

Once again "borrowing" from another area of law, the *Adams* court reported the following explanation of the rights and duties of a voluntary association:

> It remains the right of a voluntary association to make and adopt laws and regulations and to interpret them, and a member, by becoming such, subjects himself, within legal limits, to the organization's power to administer as well as make its rules. Long has it been the law of this state that courts will not interfere with this right of internal management so long as the governing body does not substitute legislation for interpretation, overstep the bounds of reason, common sense, or fairness, or contravene public policy or the laws of the land it its interpretation and administration.[83]

The *Adams* case involved an action brought for mandatory injunction to compel the American Quarter Horse Association ("AQHA") to register a filly with white markings based on a rule promulgated by the AQHA. At issue was the interpretation of a registration requirement of the AQHA. The court found that the case involved a voluntary association applying a previously adopted interpretation of its own rules.[84]

The court held that AQHA has the right to promote its declared purpose and advance the best interests of its members.[85] Whether the policy is wise is not a concern of the courts unless the committee has acted contrary to law or has been unfair in its determination.[86] The court upheld the AQHA's interpretation of its own rule.

X. CONCLUSION

Obviously, directors should concern themselves with the quality of their decisions. The dedicatory instruments typically outline the scope of the directors' authority and the process that must be followed in making decisions. By maintaining the integrity of the process for making those decisions, the directors increase their insulation from liability for their decisions.

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[1] Community Associations Institute; 2011; CAIonline.org "Industry Data."

[2] *Id.*

[3] *Id.*

[4] *Id.*

[5] Amicus Curiae Brief Community Associations Institute, *Lamden v. La Jolla Shores Clubdominium Ass'n, 72 Cal.Rptr.2d 906* (Cal. App. 4th, 1998)

[6] Tex.Civ.Prac. & Rem. Code §84.003

[7] Tex.Civ.Prac. & Rem. Code §84.003(1)(C).

[8] *Id.* at §84.003(2)

[9] *Id.*

[10] *Id.* at §84.003(4).

[11] Tex.Att'y Gen. DM-402 (1996).

[12] Tex.Att'y Gen. JM-1257 (1990).

[13] §84.004(a)

[14] §84.004(e)

[15] Tex.Att'y Gen. JM-1257 (1990).

[16] *Id.*

[17] *Cox v. Thee Evergreen Church*, 836 S.W.2d 167, 173 FN 10 (Tex. 1992).

[18] 42 USC 14501

[19] 42 USC 14501, Sec. 2 Findings and Purpose (7)(A).

[20] *Armendarez v. Glendale Youth Center, Inc*., 265 F.Supp.2d 1136, 1140 (D.Ariz. 2003) *citing* H.R. REP No. 105-101(I) at 6 (1997).

[21] 42 USC §14503 at §4(b).

[22] Id. at §4(d)

[23] *Id*. at §4(e)

[24] *Id*. at §4(f)

[25] Tex. Prop. Code Ann. §202.004(a)

[26] *Herbert v. Polly Ranch Homeowners Ass'n.*, 943 S.W.2d 906, 908 (Tex.App.—Houston [1st Dist] 1996, no writ).

[27] *Id.* at 910

[28] *Id.*

[29] *Id.* at 908

[30] *Goodrum v. State et al*, 158 S.W.2d 81, 87 (Tex.Civ.App.—Galveston 1942, writ ref'd w.o.m.).

[31] *Id.* at 83

[32] *Id.* at 87

[33] *Id.*

[34] *Webb v. Dameron*, 219 S.W.2d 581, 584 (Tex.Civ.App.—Amarillo, 1949, writ ref'd n.r.e.).

[35] *Id.*

[36] *Id.* at 585

[37] *Mitchell's Inc. v. Nelms*, 454 S.W.2d 809, 814 (Tex.Civ.App.—Dallas 1970, writ ref'd n.r.e.).

[38] *Id.*

[39] *Webb*, 219 S.W.2d. at 584

[40] *Vilbig v. Houston Authority of the City of Dallas*, 287 S.W.2d 323 (Tex.Civ.App.—Dallas 1955, writ ref'd n.r.e.).

[41] *Id.* at 330

[42] *Anderson v. Clajon Gas Co.*, 677 S.W.2d 702, 705 (Tex.App.—Houston [1st Dist.] 1984, no writ).

[43] *Id.*

[44] *Miller v. State of Texas*, 874 S.W.2D 908, 915 (Tex.App.—Houston [1st Dist] 1994, pet. ref'd).

[45] *Id.*

[46] *Zent v. Murrow*, 476 S.W.2d 875, 878 (Tex.Civ.App.—Austin, 1972, no writ).

[47] *Id.*

[48] *Id.*

[49] *Centeq v. Siegler*, 899 S.W.2d 195, 198 (Tex. 1995).

[50] *Pace v. Jordan*, 999 S.W.2d 615, 624 (Tex.App.—Houston [1st Dist.] 1999, pet. denied).

[51] *Id.* at 623

[52] *Id.*

[53] *Id.* at 624

[54] *Id.*

[55] *Bavel v. Oasis Design*, 1998 WL 54342 (Tex.App.—Austin 1998, no writ) (not designated for publication).

[56] *Id.*

[57] *Id.* at 11

[58] *Gearhart Industries, Inc., v. Smith International v. Texas American/Fort Worth N.A.*, 741 F. 2d 707, 720-721 (5th Circuit), 1984.

[59] *Id.* at 721

[60] *Id.*

[61] *Harris v. Spires Council of Co-Owners*, 981 SW2d 892, 897 (Tex.App.—Houston [1st Dist.] 1998, no pet.)

[62] *Bavel*, 1998 WL 546342 at 11

[63] *Villasana v. Patout, Cannon & Co.*, 1999 WL 1018160 (Tex.App.—Houston [1st Dist.] November 10, 1999, no writ) (not designated for publication).

[64] *Lamden v. La Jolla Shores Clubdominium Homeowners Ass'n.*, 980 P.2d 940; 21 Cal.4th 249, (CAL. 1999).

[65] *Id.* at 257

[66] *Id.* at 271

[67] *Id.*

[68] *Pooser v. Lovett Square townhomes Owners' Ass'n.*, 702 S.W.2d 226, 231 (Tex.App.—Houston [1st Dist.] 1985, writ ref'd n.r.e.).

[69] *Id.*

[70] *Id.*

[71] *Gulf Shores Council of Co-Owners v. Raul Cantu No. 3 Family Ltd Partnership*, 985 S.W.2d 667 (Tex.App.—Corpus Christi 1999, pet. denied).

[72] *Id.* at 670-671

[73] *Dutcher v. Owens*, 647 S.W.2d 948, 950 (Tex. 1983).

[74] *Frey v. DeCordova*, 632 S.W.2d 877, 880 (Tex.App.—Fort Worth 1982, writ granted).

[75] *Id.*

[76] *Frey v. DeCordova*, 647 S.W.2d 246 (Tex. 1983).

[77] *Mitchell's*, 454 S.W.2d at 814.

[78] *Id.*

[79] *Id.*

[80] *Candlelight Hills Civic Association v. Goodwin*, 763 S.W.2d 474, 478 (Tex.App.—Houston [14th Dist] 1989, writ denied).

[81] *Id.* at 482

[82] *Holleman v. Mission Trace Homeowners Ass'n, Inc.*, 556 S.W.2d 632, 636 (Tex.Civ.App.—San Antonio 1977, no writ).

[83] *Adams v. American Quarter Horse Ass'n.*, 583 S.W.2d 828, 836 (Tex.Civ.App.—Amarillo 1979, writ ref'd n.r.e.).

[84] *Id.*

[85] *Id.*

[86] *Id.* at 837