



BOARD MEMBER FIDUCIARY DUTY

A Nuts And Bolts Approach: Part II

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The Fiduciary Duty Standard in Practice

In order to provide some context for these standards, we will now look at a common situation affecting the executive board of many communities at one time or another - construction defects. The issue of construction defects can face any community, regardless of its age. For newer communities, the issue of construction defects usually involves potential claims against the builder. For older communities, a claim for construction defects could involve a roofing contractor who has completed a large re-roofing project, a contractor who replaces or upgrades deck surfaces, or perhaps a painter.

This situation usually begins with the most common of complaints - there is water leaking into the unit or units of homeowners. When faced with this situation, what should the board do to satisfy its fiduciary obligations? Should the board hire an attorney and file a lawsuit? Should the board simply fix the leak and forget about it? Or should the board avoid spending money at all costs and ignore the situation?

Looking to the standards set forth above, the first question ought to be: What are the interests of the association? In other words, regardless of how the individual board members may feel about plight of a particular owner, what are the association's responsibilities? If the project is a condominium, and water is leaking in through windows, siding or roofs, it would be likely that it is the association's responsibility to address the problem in some manner. On the other hand, if the project is a planned community in which the owners own the land and the structures, and the association is only responsible for maintenance of common recreational facilities, the association may have no responsibility.

Assuming the association has some responsibility, the next issue is what an ordinarily careful and prudent person would do. Would an ordinarily careful and prudent person ignore water leaking through one window into an owners unit? Probably not. An ordinarily careful and prudent person probably would make arrangements to have the water leak fixed by a local contractor. If two owners experienced water leaks, would an ordinarily careful and prudent person do something different? Still, probably not. However, if four or five unit owners experienced the same problem, a careful and prudent person would become concerned.

At this point, the members of the executive board, consistent with their fiduciary obligations, should be concerned about water leakage. What does the board do now, remembering, of course, that they must act as ordinarily careful and prudent people would act? Here, we turn to the third prong of the fiduciary duty standard - reasonable inquiry. How does an executive board conduct a reasonable inquiry?

Reasonable Inquiry and the Safe Harbor

Frequently, when the law imposes obligations on people, the law will also create what is commonly called a "safe harbor". A safe harbor is typically a set of guidelines that an individual can follow, and, if followed, will protect that person from liability. Nevada law provides such a safe harbor in this area. It is contained in Section 2 of NRS 82.221, which states:

"In performing their respective duties, directors and officers are entitled to rely on information, opinions, reports, books of accounts or statements, including financial statements and other financial data, that are prepared or presented by:

- (1) One or more directors, officers or employees of the corporation reasonably believed to be reliable and competent in the matters prepared or presented;
- (2) Counsel, public accountants or other persons as to matters reasonably believed to be within the preparer or presenter's professional or expert competence; or
- (3) A committee upon which the person relying thereon does not serve, established in accordance with NRS 82.206, as to matters within the committee's designated authority and matters on which the committee is reasonably believed to merit confidence; but a director or officer is not entitled to rely on such information, opinions, reports, books of account or statements if he has knowledge concerning the matter in question that would cause reliance thereon to be unwarranted."

Basically, the safe harbor allows the executive board to rely on the advice of knowledgeable experts.

Turning back to our example, when the executive board, acting as ordinarily careful and prudent people, developed a level of concern because four or five owners experienced the same leak, the board became obligated to conduct a reasonable inquiry. Because most directors have very little personal knowledge regarding construction, the board should operate within the safe harbor, and retain some kind of consultant, knowledgeable about construction, to make that inquiry.

Here we must add a warning - a director can only rely upon the opinions of experts "as to matters reasonably believed to be within the preparer or presenter's professional or expert competence." This means that a director cannot act upon the statements of another director who says his brother-in-law used to be involved in construction and says that all windows leak. In such an instance, the board members could have no reasonable belief regarding the brother-in-law's professional or expert competence. A professional manager can be of a great value in assisting an executive board in indentifying an appropriate professional or expert.

Now, because a consultant has been retained to conduct an inquiry into the nature of this problem, does that mean that the association, acting through its executive board, can or should pursue litigation? Answering this question is premature. There are a number of other questions which an executive board should ask, satisfying its duty of reasonable inquiry, before answering the litigation question.

Once the consultant has conducted a reasonable level of investigation, the consultant should report back to the executive board. The board members should then question the consultant on a variety of topics, including: (1) Does the expert have an opinion as to the cause of the problem? (2) Does the expert have an opinion as to how pervasive the problem might be? (In other words, does this problem affect only four of five owners, or is it likely to affect the whole project?) (3) What is the cost to correct this problem? (4) Does more investigation need to be done in order to answer any of the above questions?

Even after obtaining answers to these questions, the board is still not in a position to decide whether or not to pursue litigation. For example, if the project is fifteen years old and the water leakage relates to the installation of the original roof, any claim may very well be beyond the statute of limitations. The executive board must, again conducting a reasonable inquiry as a ordinarily careful and prudent person would do, consult with its attorney. The same kinds of questions ought to be asked of the attorney. (Frequently, the association's attorney is involved in selecting a construction consultant and advising the board in connection with that consultant. Here, we have separated the two inquiries for the purposes of clarifying the process.)

The questions to the association's attorney should include: (1) Are there alternatives to litigation? (2) Should the problem be brought to the attention of the contractor or builder? (3) How much is the association likely to recover if it proceeds with litigation? (4) How much is it likely to cost to obtain that recovery? (5) How long is the litigation likely to last? (6) What would be the effect of the litigation on property values? (7) What would be the effect on property values if the association elects not to proceed with litigation? (8) What is the likelihood of success if the association pursues litigation? (9) Are there any statute of limitation issues that would precluded the association from pursuing recovery if it elects to proceed with litigation?

Armed with these answers, both from a construction consultant and the association's attorney, the board is now in a position to make a decision about whether to proceed with litigation or not. It is important to note that in determining whether the executive board met its fiduciary duty, the board's ultimate decision is far less important than whether the board went through the deliberative process outlined above.

The Business Judgment Rule

This brings us to what is known as the "business judgment rule." The business judgment rule, as it pertains to common-interest communities, provides that a director who complies with NRS 116.2103 and the provision set out above will have no liability

based upon any alleged failure to discharge the person's obligations as a director. Essentially, what the business judgment rule says is that if a director acts in what he or she believes to be the best interests of the association, in an ordinarily careful and prudent manner, and after reasonable inquiry, that director is not liable, even if the decision turns out to have been an unwise one. A court will not allow the association members to second guess the decision of the directors as long as the directors have gone through the process outlined above.

The protection afforded by the business judgment rule highlights the importance of documenting in the minutes the steps taken by the executive board to conduct the reasonable inquiry.

For example, following our hypothetical situation in which four or five owners have complained of window leaks, the board might hire a consulting architect to investigate. Based on that investigation, the architect might report back to the board that, without opening up the wall, he or she is unable to determine the cause of the water leakage. The architect might also report that in the ten other windows at which he or she looked, at least half of them showed some indication that they might be leaking. Presented with this information, the Board should authorize the architect to open up the walls around two or more of the windows, perhaps one of the walls around two or more of the windows, perhaps one of the windows known to be leaking, and one of the windows suspected to be leaking. The executive board might also consider a survey of all the members to determine how many owners have an indication of water leakage around their windows.

Once the source of the water leakage and some basic information about how frequently the problem may exist in the project have been determined, the board should determine what the cost of correcting the problem would be. The cost or repair should be compared against information provided by the association's attorney as to what the likely recovery in litigation might be, the cost of obtaining that recovery, and how long the process might take.

The board is now in a position to make an informed decision. As ordinarily careful and prudent people would do, the board has not ignored the problem, but rather taken steps to determine the nature and magnitude of the problem and what the association's options are. The board has made a reasonable inquiry, and it has relied on information supplied to it by individuals whom the board members believe to be reasonably knowledgeable and competent within their area of expertise. As long as the board acts in good faith, under these circumstances, the board should be well within the scope of the business judgment rule whether or not it elects to go forward with litigation.

Again, the executive board's consideration of each of the factors outlined above should be reflected in the minutes so that the board will be able to establish to any future claimant that it satisfied its fiduciary obligations and the business judgment rule. (The reader should be aware that there are numerous statutory provisions that set forth specific

steps an association considering litigation against a builder must satisfy. A discussion of these statutes and their interplay with the executive board's fiduciary duty is beyond the scope of this article.)

Conclusion

Although the preceding discussion uses a hypothetical construction defect problem to illustrate the three prongs of the fiduciary duty standard, the same analysis could be applied to any of a variety of situations which face executive boards on a regular basis. The important factors to keep in mind are that the executive board, and each of its individual members, must act in the best interests of the association (not in the interests of any minority group of owners who elected them), must act in the same manner as an ordinarily careful and prudent person would act under like circumstances, and must only act after reasonable inquiry. Not only will meeting all three prongs satisfy a director's fiduciary obligations to the association, it is a practical approach to problem solving that will inevitably lead to positive results. ♦

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