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PRESENTS

## **Board Member Decision Making: The Business Judgment Rule Plus**

Authored and presented by

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Community Association board members face many decisions during their tenure. Being comprised of mostly lay people, community association boards often struggle with how the decisions they make will be evaluated not only by the members of the community association, but by courts. Because of this, it is important that community association boards understand how their decisions will be interpreted by courts should their decisions be challenged.

These materials will discuss the differing standards of review concerning community association board decision making. These materials will also cover trends regarding the interpretation of community association board decision making and how to safely guide boards concerning their rights and responsibilities.

## **I. Standards of Review Regarding Association Decision Making**

There are three main standards of review concerning community association Board decision making: the Business Judgment Rule, the Reasonableness Standard and, what I have coined, the Business Judgment Rule Plus or the Restatement Standard. Each standard of review covers a different aspect of board decision making, with the Business Judgment Rule Plus or the Restatement Standard being used, in some jurisdictions, as a catch all standard.

### **A. The Business Judgment Rule Standard**

The Business Judgment Rule is one of the fundamental concepts in corporate governance. The “Business Judgment Rule,” as found in a number of State Statutes<sup>1</sup> and in various cases across the country,<sup>2</sup> asserts that when a community association board member makes a decision

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<sup>1</sup> See Appendix A attached hereto

<sup>2</sup> See *Strathmore Ridge Homeowners Ass'n, Inc. v. Mendicino*, 63 A.D.3d 1038, 881 N.Y.S.2d 491, N.Y.A.D. 2 Dept.,2009; *Perlbinder v. Board of Managers of 411 East 53rd Street Condominium*, 65 A.D.3d 985, 886 N.Y.S.2d 378, N.Y.A.D. 1 Dept.,2009; *Ekstrom v. Marquesa at Monarch Beach Homeowners Ass'n*, 168 Cal.App.4th 1111, 86 Cal.Rptr.3d 145, Cal.App. 4 Dist., 2008.

that impacts the community association, the board members must take into account certain duties and responsibilities to the community. When making a decision, within the scope of his or her authority, a board member will meet his or her duty and responsibility to the community association if the board member acts: (1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner the director reasonably believes to be in the best interests of the corporation.

The Restatement (Third) of Property: Servitudes § 6.14 (2000) (the “Restatement”), which is the guiding resource concerning deed restricted communities, echoes the traditional Business Judgment Rule. Section 6.14 of the Restatement holds that the duties of the directors and officers of an association, when making a decision affecting the community association, are to act: (1) in good faith, (2) in compliance with the law and governing documents, (3) to deal fairly with the association and its members, and (4) to use ordinary care and prudence in performing their functions.

Both the traditional Business Judgment Rule and Section 6.14 of the Restatement have been used to evaluate community association decision making that involves decisions affecting the corporate governance of the community association or the relationship and decisions regarding the Board and the corporate body of the community association.<sup>3</sup> Specifically, as stated in Comment b of Section 6.13 of the Restatement “the rules in Section 6.14 govern the relationship between the directors and officers and the association.”

Corporate governance decisions usually involve: (1) how to spend the community association’s funds; (2) whether to hire and fire community association staff; (3) whether to buy or sell property or how to use said property; (4) issues concerning member elections and Board elections; and (5) the general powers of the board to operate and manage the community association.

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<sup>3</sup> See *Rywalt v. The Writer Corp., Inc.*, 34 Colo.App. 334, 526 P.2d 316 (1974) (court would not question board's decision to build tennis courts so long as taken in good faith and within exercise of honest business judgment; irrelevant that board kept incomplete minutes, held closed board meetings, and elected to build courts over other items claimed to have greater priority); *Farrington v. Casa Solana Condominium Ass'n, Inc.*, 517 So.2d 70 (Fla.Dist.Ct.App.1987) (special assessment for repairs was valid, since board exercised reasonable business judgment in determining it was necessary).

One of the key facets of the traditional Business Judgment Rule and Section 6.14 of the Restatement is that, when the rule's requirements are met, and there are no allegations of fraud or bad faith, a court will not substitute its judgment for that of the corporation's board of directors.<sup>4</sup>

Courts across the country have applied the Business Judgment Rule to community association decision making. Commenting on possible rationales for the use of the Business Judgment Rule by courts, the Restatement at §6.13, Comment b states:

[A]doption of the business-judgment rule is intended to reduce the ease with which disgruntled members can obtain judicial review of association decisions and to discourage judges from substituting their judgment for that of the association. Adoption of the business-judgment rule may also be intended to reduce the disincentives to serve as a director or officer of an association by reducing the threat of personal liability for honest mistakes in judgment.

Corporate governance issues, however, do not compromise the sum of board decision making. Community associations also make decisions concerning the enforcement of restrictive covenants. These types of decisions are evaluated using another standard of review, the Reasonableness Standard.

## **B. The Reasonableness Standard**

In reviewing the regulatory actions of an Association's governing body concerning the enforcement of restrictive covenants, some Courts have adopted a Reasonableness Standard. When applying this standard and reviewing the Board's decisions, Courts will consider the following: (1) whether the actions were taken within the legal powers granted it by law or the

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<sup>4</sup> If a board of directors is operating within the scope of the association's authority and in good faith, courts will not review the decision of the board. The presumption is that the board acted reasonably and judicial review is unavailable. See *Levandusky v. One Fifth Ave. Apartment Corp.*, 554 N.Y.S.2d 807, 812, 553 N.E.2d 1317, 1322 (N.Y.Ct.App. 1990); (Judicial review of an association's actions generally is not available "[s]o long as the board acts for the purposes of the [community], within the scope of its authority and in good faith."); *Black v. Fox Hills North Cmty. Ass'n, Inc.*, 90 Md.App. 75, 81, 599 A.2d 1228, 1231(1992). (Finding that business judgment rule precluded review of community association's decision concerning construction of fence where "the decision fell within the legitimate range of the association's discretion" and "[t]here was no allegation ... of any fraud or bad faith"); *Rywalt* at 317. (deferring to business judgment of homeowners association concerning construction of tennis court when there was "no evidence that the directors acted in bad faith or in fraud of the rights of the members."); *Lamden v. La Jolla Shores Clubdominium Homeowners Assn.* 21 Cal.4th 249, 980 P.2d 940, 87 Cal.Rptr.2d 237, (Cal. 1999)(Court adopted the "judicial deference" standard to community-association-board decision-making that applies when owners in common interest developments seek to litigate ordinary maintenance decisions of their associations' board of directors).

governing documents; (2) whether the actions “bear a relationship to the health, happiness, and enjoyment of life of [the owners]; (3) whether the regulations result in an unfair or disproportionate impact on a select number of owners; and (4) whether the owners had notice of the Board’s authority to regulate.”<sup>5</sup>

The Reasonableness Standard was used by a Florida Court in reviewing a use restriction not mandated by the Association’s governing documents, but rather created by the Board invested with the power to grant or deny the particular use. *Hidden Harbour Estates, Inc. v. Basso*, 393 So.2d 637 (Fla.Dist.Ct.App.1981). In *Hidden Harbour* the board denied an application for permission to drill a well. In reviewing the Board’s decision, the Court looked to whether it was “reasonably related to the promotion of the health, happiness and peace of mind of the unit owners.” The Court further found that “where the decision to allow a particular use is within the discretion of the board, the board must allow the use unless the use is demonstrably antagonistic to the legitimate objectives of the condominium association.” *Id.* at 640. Ultimately, the court found that the board acted unreasonably because the board “failed to demonstrate a reasonable relation between its denial of the application and the objectives which the denial sought to achieve.” *Id.*

The Reasonableness Standard differs from the Business Judgment Rule because under the Reasonableness Standard, the board is not granted the same level of deference in its decisions. As a result, the Board is left to prove that its actions and decisions were reasonable and there is not a presumption that the board acted within its realm of authority.<sup>6</sup> The Restatement at §6.13, Comment b, states:

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<sup>5</sup> See *Johnson v. Hobson*, 505 A.2d 1313 (D.C.Ct.App.1986) (decision to tow unregistered cars from condominium lot was reasonable when rule was adopted at association meeting and two warnings were placed on cars before they were towed); *Hidden Harbour Estates, Inc. v. Norman*, 309 So.2d 180 (Fla.Dist.Ct.App.1975) (“If a rule is reasonable the association can adopt it; if not, it cannot...Of course, this means that each case must be considered on the peculiar facts and circumstances thereto appertaining.”); *Makeever v. Lyle*, 125 Ariz. 384, 388-89, 609 P.2d 1084, 1088-89 (Ct.App.1980); *LeFebvre v. Osterndorf*, 87 Wis.2d 525, 533, 275 N.W.2d 154, 145 (Ct.App.1979).

<sup>6</sup> See also *Laguna Royale Owners Ass'n v. Darger*, 119 Cal.App.3d 670, 174 Cal.Rptr. 136 (1981) (denial of consent to transfer to 4 owners with serial use rights to 13 weeks each was unreasonable and improper in absence of proof by association that proposed use by transferees would substantially interfere with peaceful enjoyment of other residents or effective security; action was also inconsistent with bylaw prohibiting rentals for less than 90-day periods with stated rationale that shorter periods would interfere with orderly administration and security); *Chateau Village North Condominium Ass'n v. Jordan*, 643 P.2d 791 (Colo.Ct.App.1982) (board acted unreasonably in adopting blanket pet prohibition rather than considering all applications for permission to keep pets and exercising its discretion to grant permission in reasonable and good-faith manner where bylaws provided that no animals should be kept unless expressly permitted in writing by the managing agent or board of managers);

[F]ollowing a statement in an early Florida case, some courts, most notably in California, require the association affirmatively to prove the reasonableness of any covenant, rule or decision it sought to enforce or uphold as a predicate for seeking injunctive relief. That position, which probably was rooted in the historic distrust for covenants running with the land, was ill-advised and has since been repudiated by the California Supreme Court.

It can be argued that the Reasonableness Standard creates a greater incentive for a member to file a lawsuit if the burden is on the Association to prove that its regulatory actions were reasonable under this Standard. The Reasonableness Standard is still applied when reviewing decisions made by Associations regarding restrictive covenants. However, another standard exists that tends to combine the Reasonableness Standard with aspects of the Business Judgment Rule.

### **C. A New Standard – The Business Judgment Rule Plus**

Although the Business Judgment Rule and the Reasonableness Standard are currently implemented by Courts, a new standard is emerging; one that blends the Business Judgment Rule and the Reasonableness Standard. This standard, which I refer to as the Business Judgment Rule Plus, as provided for in case-law and as proposed in the comments of the Restatement at Sections 6.13, combines the requirements of Section 6.13 and 6.14 of the Restatement along with the principles of the Business Judgment Rule and Reasonableness Standard.

Restatement 6.13 adopts aspects of both Standards. It requires an Association to (1) use ordinary care and prudence in managing the property and financial affairs of the community that are subject to its control; (2) to treat members fairly; (3) to act reasonably in the exercise of its discretionary powers including rulemaking, enforcement, and design-control powers; and (4) to provide members reasonable access to information about the association, the common property, and the financial affairs of the association. It also imposes a duty on the members to prove a breach by the Association of these duties.

In discussing this standard, the Restatement, at Comment b, Section 6.13, states:

These rules are intended to protect common-interest communities against excessive litigation and unnecessary judicial interference with collective

decisions, but at the same time to protect individual community members from careless and risky management practices, unreasonable exercise of discretionary powers, and unfair treatment at the hands of those who control the association. They provide the advantages of the business-judgment rule, but at less potential cost to the interests of individual members. The business-judgment rule is not adopted because the fit between community associations and other types of corporations is not very close, and it provides too little protection against careless or risky management of community property and financial affairs.

At present time, jurisdictions across the country are creating and relying on standards as applied to decisions made by Association Board of Directors that combine, to varying degrees, the Business Judgment Rule, the Reasonableness Standard, and the Restatements.

New Jersey courts have applied a combination of the business judgment rule and a reasonableness standard. *Papalexiou v. Tower West Condominium*, 167 N.J. Super. 516 (N.J. Ch. Div. 1979). In *Papalexiou*, a homeowners' association faced an emergency and needed to replace leaks throughout the association's buildings. The board of directors levied a \$100,000 special assessment on the condominium owners and one owner filed suit. The court, in ruling in favor of the Association, applied a two part test to determine whether the board acted within its authority or if it breached its fiduciary duty. The court first considered and applied a reasonableness standard determined by the "health, happiness and welfare of the majority of the owners." The court then applied aspects of the business judgment rule to see if the board acted within its authority, and in determining the motivation for the special assessment.<sup>7</sup> The court found that because the bylaws provided for special assessments in emergency cases the board acted within its authority and that its actions were reasonable in trying to maintain the welfare of the community. It was further held that the determination of the Association's emergency would not be judicially reviewed

The Supreme Court of North Dakota has adopted a similar test to that of the New Jersey Courts. The court in *Buckingham v. Weston Vill. Homeowners Ass'n*, 571 N.W.2d 842 (N.D.

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<sup>7</sup> See also *Thanasoulis v. Winston Towers 200 Association Inc.*, 110 N.J. 650 (1988); The Appellate Division applied a two part test to determine whether the business judgment rule could be applied; (1) was the action authorized by statute or by the association's governing documents, and (2) whether the action was fraudulent, self-dealing or unconscionable; see also *Farrington v. Casa Solana Condominium Ass'n, Inc.*, 517 So.2d 70 (Fla. Dist. Ct. App. 1987) (special assessment for repairs was valid, since board exercised reasonable business judgment in determining it was necessary); *Killearn Lakes Homeowners Ass'n v. Sneller*, 418 So.2d 1214 (Fla. Dist. Ct. App. 1982) (board had authority to locate tot lot within green area under provision permitting installation of recreational facilities; contrary decision would border on judicial invasion of board's discretionary management function).

1997), held that the reasonableness standard applies when dealing with any rule, regulation, or amendment to the declaration or bylaws, but in setting forth said standard relied on aspects of the business judgment rule. The Court considered (1) whether the decision or rule is arbitrary, (2) whether the decision or rule is applied in a discriminatory manner (3) whether the decision or rule was made in good faith for the common welfare of the owners in the association. *Id.* at 844-845

An Arizona Court was presented with a similar situation where a the lower court ruled against an Association seeking injunctive and declaratory relief to declare that its Architectural Committee properly exercised its authority in disapproving a homeowner's garage construction that was done without obtaining the requisite approval. *Tierra Ranchos Homeowners Ass'n v. Kitchukov*, 216 Ariz. 195, 204, ¶ 37, 165 P.3d 173, 182 (App.2007) In *Tierra Ranchos*, the Arizona Court of Appeals established a standard of review for disputes arising within common interest communities between members and the association. The Court held:

The Restatement approach blends elements of the reasonableness rule and the business judgment rule. The purpose of imposing these burdens on the member is to protect “the collective decision-making processes of common-interest communities from second-guessing by the judiciary and to protect the community from the expenses of too-ready resort to litigation by disgruntled community members, while at the same time protecting individual members from improper management and imposition by those in control of the association.” *Id.* at cmt. a. As the comments indicate, “[t]he business-judgment rule [was] not adopted because the fit between community associations and other types of corporations is not very close, and it provides too little protection against careless or risky management of community property and financial affairs.” *Id.* at cmt. b. Nonetheless, unlike jurisdictions requiring the association to prove the reasonableness of its actions, the Restatement approach requires the member challenging the association to establish that its actions were unreasonable. *Id.* The Restatement approach essentially “provide[s] the advantages of the business-judgment rule, but at less potential cost to the interests of individual members.” *Id.*

The Arizona Court of Appeal, in adopting the Restatement 6.13 as the standard, decided that the business judgment rule was not the correct standard to apply to community associations in Arizona. The Court ultimately held that a fact finder could find that the Association's decision was reasonable and reversed and remanded the case back to the trial court.

Confusion can be created in some cases where this standard blends the reasonableness rule and the business judgment rule and even use the terms “reasonableness” and “business

judgment” interchangeably without fully adopting either standard.<sup>8</sup> This was the case in *Cedar Cove Efficiency Condominium Ass’n v. Cedar Cove Properties, Inc.*, 558 So. 2d 475, 479-480 (Fla. Dist. Ct. App. 1990), where the court stated they would follow the “business judgment rule” when reviewing the decisions of a board of directors, but only if the board acted in a “reasonable” manner.

## II. CONCLUSION AND TRENDS

Whether a jurisdiction uses the Reasonableness Standard or the Business Judgment Rule, the general trend in courts today pulls from both of these standards. Whether we coin this new standard as the Business Judgment Rule Plus or the Restatement Standard, it is becoming clear that the Business Judgment Rule alone does not provide enough protection for the members of a common interest community, while the Reasonableness Standard lacks sufficient protection for board members who are likely unfamiliar with board member duties and practices.

The Business Judgment Rule Plus or the Restatement Standard molds together the protection of the business judgment rule, while accounting for the rights of an association’s members by not fully insulating board members and making them liable for unreasonable decisions and judgments.

Advising community association boards to be aware of the Business Judgment Rule Plus or the Restatement Standard when making decisions is a conservative approach, as not all jurisdictions have adopted this standard of review. Due to the ambiguity, it is advisable that boards be made aware of all standards of review.

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<sup>8</sup> Vincent Di Lorenzo. *Judicial Deference to Management Decisions in Planned unit Developments*. 15-Feb Prob. & Prop. 20, (2001).

## APPENDIX A

### Board Member Liability and Duty by State

State	Statute
<b>Alabama</b>	Code of Ala. §§ 10-2B-8.30 through 10-2B-8.33 Code of Ala. § 10-2B-8.42
<b>Alaska</b>	Alaska Stat. § 10.06.480
<b>Arizona</b>	A.R.S. §§ 10-830 through 10-833, A.R.S. § 10-842
<b>Arkansas</b>	Ark. Stat. Ann. § 4-26-811
<b>California</b>	Cal Corp Code § 309
<b>Colorado</b>	C.R.S. § 7-108-401 through 7-108-403
<b>Connecticut</b>	Conn. Gen. Stat. §§ 33-756 through 33-757 Conn. Gen. Stat. § 33-765
<b>Delaware</b>	8 Del. C. § 142
<b>Washington DC</b>	D.C. Code § 29-101.42
<b>Florida</b>	Fla. Stat. §§ 607.0830 through 607.0831
<b>Georgia</b>	O.C.G.A. §§ 10-5A -7 and O.C.G.A. §§14-2-830 through 14-2-832
<b>Hawaii</b>	HRS §§ 414-221 through 414-223
<b>Idaho</b>	Idaho Code § 5-237
<b>Illinois</b>	805 ILCS 5/8.65
<b>Indiana</b>	Ind. Code. Ann. §§ 23-1-35-1 through 23-1-35-4
<b>Iowa</b>	Iowa Code §§ 490.830 through 490.831
<b>Kansas</b>	K.S.A. § 17-7101
<b>Kentucky</b>	KRS §§ 271B.8-300 through 271B.8-330
<b>Louisiana</b>	La. R.S. 12:92
<b>Maine</b>	13-C M.R.S. § 831 through 13-C M.R.S. § 833
<b>Maryland</b>	Md. CORPORATIONS AND ASSOCIATIONS Code Ann. § 2-405.2
<b>Massachusetts</b>	ALM GL ch. 156, § 36 through ch. 156, § 38
<b>Michigan</b>	MCLS § 450.1541a
<b>Minnesota</b>	Minn. Stat. § 317A.251
<b>Mississippi</b>	Miss. Code Ann. §§ 79-4-8.30 through 79-4-8.33
<b>Missouri</b>	§ 351.345 R.S.Mo.
<b>Montana</b>	Mont. Code Anno., § 35-2-416
<b>Nebraska</b>	R.R.S. Neb. §§ 21-2095 through 21-2099
<b>Nevada</b>	Nev. Rev. Stat. Ann. § 78.138
<b>New Hampshire</b>	RSA 293-A:8.30 through 293-A:8.33
<b>New Jersey</b>	N.J. Stat. § 15A:6-14
<b>New Mexico</b>	N.M. Stat. Ann. § 53-4-18.1
<b>New York</b>	NY CLS Bus Corp § 717
<b>North Carolina</b>	N.C. Gen. Stat. § 55-8-30
<b>North Dakota</b>	N.D. Cent. Code, § 10-19.1-50

<b>Ohio</b>	OAC Ann. 5703-9-49
<b>Oklahoma</b>	18 Okl. St. § 867
<b>Oregon</b>	ORS §§ 60.357 through 60.367
<b>Pennsylvania</b>	15 Pa.C.S. § 513
<b>Rhode Island</b>	R.I. Gen. Laws § 7-1.2-811
<b>South Carolina</b>	S.C. Code Ann. §§ 33-8-300 through 33-8-330
<b>South Dakota</b>	S.D. Codified Laws §§ 47-1A-830.1 through 47-1A-833.1
<b>Tennessee</b>	Tenn. Code Ann. §§ 48-18-301 through 48-18-304
<b>Texas</b>	Tex. Bus. Corp. Act art. 2.41
<b>Utah</b>	Utah Code Ann. §§ 16-10a-840 through 16-10a-842
<b>Vermont</b>	11A V.S.A. § 8.30 through 11A V.S.A. § 8.33
<b>Virginia</b>	Va. Code Ann. § 13.1-547
<b>Washington</b>	Rev. Code Wash. (ARCW) § 23B.08.420
<b>West Virginia</b>	W. Va. Code §§ 31D-8-831 through 31D-8-833
<b>Wisconsin</b>	Wis. Stat. § 180.0828
<b>Wyoming</b>	Wyo. Stat. 17-16-830§ 17-16-830 through 17-16-833

#### **The Business Judgment Rule Plus Statutes by State**

STATE	STATUTE
<b>Arkansas</b>	<a href="#">Ark. Code § 4-33-830</a>
<b>California</b>	<a href="#">Cal. Corp. Code § 7231</a>
<b>Kentucky</b>	<a href="#">Ky. Rev. Stat. Ann. § 411.200</a>
<b>Louisiana</b>	<a href="#">La. Rev. Stat. Ann. § 12:226</a>
<b>New York</b>	<a href="#">I.R.C. § 501(c)(3)</a>
<b>Pennsylvania</b>	<a href="#">42 Pa. Cons. Stat. Ann. § 8332.2</a> and <a href="#">68 Pa.C.S.A. § 5303</a>
<b>Washington</b>	<a href="#">Wash. Rev. Code § 64.38.025</a>