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BOARD MEMBER
DUTIES AND LIABILITIES
IN
COLORADO OWNER ASSOCIATIONS

An article on how directors can minimize personal liability with recommended best practices

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1) INTRODUCTION TO COLORADO OWNER ASSOCIATIONS AND THE DUTIES OF DIRECTORS

a) Number of Associations in Colorado. Colorado has an estimated 13,000 to 15,000 owner associations.

b) Types of Associations. Colorado owner associations can be property owner associations, single family owner associations, townhome associations, condominium associations and more. The community governed and operated by the association may be small to large (from 2 homes or properties, to over 40,000 homes).

c) Associations are typically private nonprofit Colorado corporations. Most Colorado associations are incorporated as a Colorado nonprofit, or if not incorporated, act as a nonprofit entity. The purpose is not to provide investment returns or stock dividends to shareholders, since there are no shareholders. The purpose is typically to preserve, enhance and protect the values of the properties of members. While a nonprofit, associations are similar to big businesses in many ways. Associations are confronted with various governance, maintenance and operational tasks. Typically, a community association is governed by a board of directors and the board operates the association. Some boards of directors may be responsible for five, six and seven figure annual budgets. Associations are not part of government and directors are not treated like publicly-elected officials. As persons privately elected or appointed to govern a private nonprofit corporation, directors owe duties to the association and the members. Those duties are reviewed and discussed in this article.

d) Colorado Statutes That Apply. As nonprofit corporations, Colorado owner associations are primarily subject to two different state statutes (in addition to the State and Federal Constitutions and other laws): the Colorado Revised Nonprofit Corporation Act and the Colorado Common Interest Ownership Act.

  i) Colorado Revised Nonprofit Corporation Act. This statute covers many areas dealing with Colorado nonprofit corporations. The provisions of this statute on duties and liability of board members are the focus of this article.

  ii) Colorado Common Interest Ownership Act. This state statute, referred to and known by its acronym CCIOA, is not the focus of this article.

  iii) What about conflicts between the Nonprofit Act and CCIOA? At times, both corporate law and the law of common interest communities, under CCIOA, may apply with differing results. When that happens, associations should consult with their attorney.

e) Associations have perpetual life and rarely go out of business or file bankruptcy. Think about it! Associations are perpetual organizations for the benefit of their members. As long as the members do not terminate the covenants and the community, the association continues in existence. It cannot liquidate without the approval (through amendment or termination) of its members. This means the association should be prudent in how it operates, governs, and contracts with, etc., since Chapter 7 bankruptcy liquidation is not possible, unless the community is to terminate.

2) GENERAL DISCUSSION ON DUTIES OF DIRECTORS OF NONPROFIT CORPORATIONS

Directors of Colorado owner associations have duties set out in the Colorado Revised Nonprofit Corporation Act and in CCIOA. These duties are similar to the duties of other for profit business operations. These responsibilities are generally owed to the association and to its members, not to the general public or the world at large. This article focuses on duties under the Colorado Revised Nonprofit Corporation Act.

3) THE PRIMARY DUTY: THE DUTY OF CARE AND THE STANDARD OF CONDUCT

a) Three Key Components of the Standard of Conduct. Under the terms of the Colorado Revised Nonprofit Corporation Act, directors must discharge their duties:

i) In good faith (all directors are obligated to act in good faith).

ii) With the care an ordinarily prudent person in a like position would exercise under similar circumstances (all directors are obligated to act with the care an ordinarily prudent person in a like position would exercise under similar circumstances); and

iii) In a manner the director reasonably believes to be in the best interests of the association (all directors are obligated to act in a manner the director reasonably believes to be in the best interests of the association).

CCIOA NOTE: For owner associations that govern common interest communities created after July 1, 1992, CCIOA states that directors (those not appointed by the declarant) shall not be liable for actions taken or omissions made in the performance of their duties except for wanton and willful acts or omissions. Prudence dictates that all directors adhere to the standard of conduct set forth in the Nonprofit Act.

4) HOW TO LIMIT LIABILITY/FOUR MEANS OF PROTECTION TO COMPLY WITH THE STANDARD OF CARE AND OTHER DUTIES

a) Directors should comply with duties and seek to limit liability. Directors should act in ways designed to comply with their duties and to limit liability.

Any individual who considers service on a community association board of directors owes a duty to himself/herself to understand the standard of care (and other duties) and to determine if limitations on personal liability available under state law are available to the directors. Directors can then safely serve their association without putting his or her personal assets at risk.

b) Four Means of Personal Protection for Directors.

i) Statutory and Case Law Limitations.

(1) Case Law Limitation - The Business Judgment Rule. When a court reviews the action or lack of action of board members or of an Association, the court typically applies the "Business Judgment Rule."

The Business Judgment Rule is a legal concept, as well as established case law, applying to nonprofit and for-profit business corporations, including owner associations.

Under the terms of the Business Judgment Rule, a court will not reexamine the actions of a board or an association in authorizing or permitting an association action if the directors' action was undertaken in good faith in a manner reasonably believed to be in the best interests of the association, and with an independent and informed judgment (i.e., the director met the standard of care identified by the statutory criteria set forth above). The doctrine is a statement by the courts that it is inappropriate for the court to "second guess" the decisions of boards, even if those decisions turn out to be unwise or unsuccessful.

(2) Statutory Limitations.

(a) Limitations on Personal Liability/Inclusion of Express Authority in the Articles of Incorporation. Under the terms of the Nonprofit Act "if so provided in the articles of incorporation," the association "shall eliminate or limit the personal liability of a director to the nonprofit corporation or to its members for monetary damages for breach of fiduciary duty as a director."

<u>Exceptions</u>. This limitation on personal liability does not apply to monetary damages for:

- any breach of the director's duty of loyalty to the association or to its members;
- acts or omissions not in good faith or that involve intentional misconduct;
- a knowing violation of law; or
- any transaction from which the director receives an improper personal benefit.

<u>Express Authority Required</u>. It is important to note that this statutory limitation is only effective if expressly provided for in the association's articles of incorporation. Associations incorporated before this statutory limitation became available are likely not to have this protection and should consider amending their articles of incorporation to include this protection. Many associations incorporated after this limitation was allowed by statute do not have this authority.

(b) <u>Tort Injuries Limitation</u>. A director will not be liable for injuries resulting from an association employee's tort (i.e., intentional or negligent misconduct) unless the director was personally involved in the situation or committed a crime in connection with the situation.

The director could be liable if the director participates in or instructs the employee to commit the tortuous act or the director acts to destroy evidence after the fact.

It should be noted that even if the director is not personally liable for an association employee's torts, the association, as the employer may be liable.

ii) <u>Indemnification</u>. Indemnification is the agreement or duty of one party to protect another from loss or damage. In the case of directors, this agreement can be either express or inferred. Directors are viewed as agents for their principal, the association.

Under the general law of principals and agents, an agent is entitled to be indemnified by its principal for claims arising out of the agent's acts within the scope of its duties. This protection includes the responsibility of the principal to furnish the agent a defense against claims asserted against the agent by third parties.

As an agent of an association, a director is entitled to have the association pay any successful claims asserted against him/her for authorized acts within the scope of his/her authority as a director, and to have the association furnish him/her a defense against the claim.

The Nonprofit Act also provides that a nonprofit corporation may indemnify its directors against claims asserted against them for acts taken in the discharge of their duties as directors.

Finally, it is common for association governing documents to include express language requiring the association to indemnify its officers and directors from both claims and the cost of defending claims against them arising from their actions as directors. Frequently, such documents will exclude from indemnification protection, claims arising from deliberate wrongdoing, gross negligence and fraud.

Directors' and officers' insurance (addressed below) is used by associations to fund their indemnification obligations. Without insurance to fund the indemnification obligation, the association may have to levy a special assessment against its members to fund the obligation.

iii) Directors’ and Officers’ Insurance. Directors’ and Officers’ insurance (or professional liability insurance) protects individuals who serve as directors or officers from a number of types of claims asserted against them arising from their actions as directors or officers. But be careful. The quality of and types of policies varies widely.

This insurance is an important part of a director’s means of protection because it will pay the costs to defend against claims. The cost of defending claims, even groundless claims, can be prohibitive if it must be borne by an association or an individual director.

In considering this form of protection for directors, it is essential to recognize that there is no uniform contract of insurance as there are for other types of coverage. As a result, the format and the coverage will vary dramatically from policy to policy. In order to appreciate the value of any particular directors’ and officers’ insurance policy (“D&O policy”), one has to study it carefully. For example, it is generally necessary to study both the definitions section and the exclusions section of a policy to fully evaluate the protection the policy offers. Some policies will protect and defend only against monetary claims. Other, broader policies will cover against claims of “wrongful acts.”

Generally, there are two types of coverage available in D&O insurance policies. Most policies will only cover claims or furnish a defense when the claim asserted is for money damages. Under these policies, no defense will be furnished when the claim is for equitable relief. A limited number of carriers offer coverage that will defend directors from any claims, without regard to whether money damages are sought. Among other important considerations in reviewing D&O policies are the following:

- Umbrella policies may increase a D&O policy. Thus, low limits of D&O coverage may be dangerous.
- With very limited exceptions, D&O insurance carriers do not insure any directors on a board that includes developer-appointed members.
- No currently available D&O policy will cover claims for punitive damages.
- Most D&O policies do not cover slander, libel or defamation, although such coverage may be offered as an endorsement to the policy.
- All D&O policies exclude claims for pollution, leaving claims against the directors related to environmental issues unprotected unless picked up by other insurance.

iv) Careful Practices/Risk Management. The value of being thoughtful and careful as a director, as a means of self-protection, continues and should be exercised by directors.

As noted above, in reviewing the conduct of directors in response to a claim by their association or its members, the Business Judgment Rule examines the steps that directors took in arriving at business decisions and protects them from liability, if the decisions were reached through appropriate steps in accordance with the standard of care.

In reviewing the conduct of directors in the face of claims by third parties, courts will generally find directors' acts to be the acts of the association, not their own. Therefore, the directors will not be liable unless they intentionally act wrongfully or unless they ratify acts they know to be wrong.

Careful practices will warn directors of potential conflicts of interest and help them to avoid circumstances in which their undivided loyalty can be called into question. For developer-appointed directors and owner-elected board members, those practices that will help the red flags to go up that are critical to avoiding claims of breach of fiduciary duty.

Every association should put into place a risk management program. Risk management is the affirmative action taken by an association to minimize exposure to liability and reduce expenditures for damages, costs and attorney fees. Through a risk management program, an association's exposure to liability is minimized by the proper use of insurance (general liability, casualty, D&O, and worker's compensation); risk transfer methods (contracts, licenses, releases, indemnifications, etc.) and risk avoidance procedures (on-site inspections, proper rules and enforcement procedures, etc.).

c) Specific Recommendations on How to Comply With the Standard of Care and Other Duties.

i) Exercise independent judgment. Each director, no matter how selected, shares in all the responsibilities and powers of the directors. Each director should exercise her or his independent judgment on all association decisions. The law views a board of directors as an entity, each member of which shares the same rights and the same duties, and each member of which is accountable to the same constituency. Even if other parties may regard a director as representing a particular group or interest, these considerations do not affect the director's duties to the entire organization. The director's responsibilities will be the same as those of any other director. If the board decides to delegate a task to a particular director, that is a decision of the board, not of the constituency or body which selected or suggested the director.

ii) Dedicate the time required. Do not be a director unless you will spend the time it takes to do the job. Your community association is not a social club. It is a business that requires professionalism of its board of directors. Central to such an approach is spending the time it takes to do the job properly.

iii) Attend board meetings and participate in decision making. Directors act as a group, not as individuals, so attendance at board meetings is important. Continuous or repeated absence may expose the director to the risk of not satisfying the standard of care. Sporadic board attendance also reduces the morale of those who do attend. It should be understood that directors cannot vote or participate in board meetings by giving a proxy to another director, unless that authority is within the bylaws and if such authority exists, the proxy authority is limited to "directed" matters and not to all business that comes before the board.

iv) Understand the association and its operations. This means knowing and understanding the association's authority and responsibilities, as defined in its governing documents and by practice, its finances, its management and its relationship with its members. Responsible decisions are most possible when directors understand the community they serve.

v) Be alert. Be critical in reviewing the information furnished to you concerning the operations of the association. Early reaction to major trouble is often the greatest service a director can do. Lethargy in the face of such trouble promises loss to the association and claims against an active director. Most associations require their boards of directors to meet regularly and, absent special circumstances, to make their decisions in meetings. This is based on the valid conclusion that the process of listening, asking and speaking leads to better decisions. In order to be able to be active, get informed. Ask for information about decisions that are to be made and then study what you are given in advance of the meeting at which the decision is to be made.

vi) Select and then support good management. As volunteers, most community association directors cannot and should not become involved in the detailed management of an association. Rather, the directors must employ good management and regularly evaluate its performance. So long as your assessment of management is positive, support it and rely on it to help you in making informed decisions.

vii) Do not accept special treatment. Altruism in its most rigorous form should control your decision to be a director and should characterize your service. Even the most inconsequential compensation or special consideration will prove indefensible when raised at an annual meeting or during a deposition.

viii) Avoid undisclosed conflicts of interest. Any transaction with the association should be at arm's length and for the association's benefit, not yours. Every such transaction should be fully disclosed and memorialized. Be sure to follow the association's governing documents and policies and be sure that other directors do likewise.

ix) Document association actions. Have the minutes reflect the process that was followed and the advice received for all major decisions.

x) Insurance and Indemnification. Do not serve without broad indemnification and a limitation of personal liability in the governing documents nor without adequate D&O insurance protection and a fidelity bond.

xi) Become and stay educated on duties and best practices. Attend a presentation by association's legal counsel on fiduciary duties of directors and applicable statutes.

xii) Prepare a risk management program. Adopt a comprehensive risk management program designed to minimize liability and reduce damages in the event of liability.

xiii) Get independent advice and be informed. To function effectively a director needs to be informed and, therefore, needs to have an adequate source of information flow. This information is often supplied by the property manager. To the extent that it is not adequate, a board or an individual director will have to determine what additional information is needed.

The director should read the information with which he or she is supplied, even when the director has total and justified confidence in the individual supplying the information. In general, the board may rely on information supplied by the property manager but if for any reason any member of the board thinks that it is inadequate in any respect, he or she should not hesitate to request further information.

xiv) Allowed Reliance on Others. Under the terms of the Nonprofit Act, in discharging duties, a director is entitled to rely on information, opinions, reports, or statements,

including financial statements and other financial data, if it is prepared or presented by:

- one or more officers or employees of the association whom the director reasonably believes to be reliable and competent in the matter presented;
- legal counsel, a public accountant, or another person as to matters the director reasonably believes are within such person's professional or expert competence; and
- a committee of the board of directors of which the director is not a member, if the director reasonably believes the committee merits confidence.

xv) Expert Advice. Seek the advice of professionals and then listen to the advice. Good directors recognize that they are generalists who, in order to be adequately informed, often need the advice of specialists.

Directors should seek the advice of community association managers, accountants, lawyers, engineers, contractors, and the like, as circumstances require. The professionals may not always be right and it may be a good decision to reject their advice in any particular case. However, prudence requires that business decisions be based upon available expertise and, if the advice of experts is rejected, reasons for rejecting the advice should be documents.

Decisions should not be made solely because a particular outcome is popular or merely to quiet dissention.

Later, when hindsight is sharpest, decisions made solely because they are popular or quiet dissension will do little to protect a director who has made a decisions that cannot be defended by the business Judgment Rule. A director who exercises good faith judgment will usually be protected from liability to the association or to its membership under the Business Judgment Rule.

Special knowledge of a director must be exercised. The Nonprofit Code provides that a director or officer is not acting in good faith if the director has knowledge concerning the matter in question that makes reliance otherwise permitted above unwarranted.

5) DUTY OF UNDIVIDED LOYALTY

Directors have a duty to act for the association's benefit only and not for their personal benefit or the benefit of others.

Courts take this duty seriously, often using expressions such as "utmost good faith" and placing the burden on the director to demonstrate the fairness of any transaction in which the director is personally involved if the transaction is challenged.

The duty of loyalty requires directors to exercise their powers in the best interests of the association rather than in their own interest or the interest of another entity or person.

By assuming office, directors acknowledge that, with regard to any association operations or governance, the best interests of the association must prevail over the director's individual interests or the particular interests of the members electing him or her.

The basic legal principle to be observed here is a negative one: a director shall not use his or her position for individual personal advantage.

6) DUTY TO AVOID CONFLICTS OF INTEREST

a) Conflicts Defined. A conflict of interest is present whenever a director has a material personal interest in a proposed contract or transaction to which the association may be a party. This interest can occur either directly or indirectly. The director may be personally involved with the transaction, or may have an employment or investment relationship with an entity with which the association is dealing, or it may arise from some family relationship. A conflict of interest may result from a director performing services for the association (e.g., a landscape contractor, banker, insurance agent, attorney or real estate broker). The board should not assume that a conflict cannot exist for a director who receives no monetary or other tangible benefit from a transaction with the association. For example, access to information which could be used for individual profit might put the director in conflict with the association. The law seeks to recognize these problems, not by treating conflicts of interest as inherently a moral or legal offense, but by prescribing the methods by which the board of directors and the individual directors should disclose conflicts and how they should proceed in the face of such situations.

b) Senate Bill 05-100. Undisclosed conflicts of interest involving a director were not illegal, if the transaction was fair or disclosed and approved by members, or disclosed and approved by disinterested board members, until Senate Bill 05-100 ("SB 100") and January 1, 2006. The illegality of conflicts of interest under SB 100 was returned to the prior standard on May 26, 2006, with Senate Bill 06-89. For that time frame, if a contract would financially benefit any board member or any person who is a parent, grandparent,

spouse, child or sibling of a board member or parent or spouse of any of those persons, the board member is required to disclose and declare the conflict of interest in an open meeting prior to any discussion or action on that issue and that board member could participate in the discussion but not vote. Under SB 100, any contract entered into in violation of this provision was void.

c) Conflict of Interest Policy. SB 100 required all associations to adopt a conflict of interest policy. If an association does not have that policy, one should be adopted and maintained.

d) Timeshare Exception. The section of SB 100 that precluded conflicts of interest transactions does not apply to an association that includes time-share units.

e) Senate Bill 06-89. Senate Bill 06-89 returned the law to the previous standard, as set in the Nonprofit Act.

f) Nonprofit Act Approach to Conflicts. Under the Nonprofit Act, conflicting interest transactions are voidable, but not necessarily void. In general, a director's conflict will be cleared of any consequence by any one of the following options: full disclosure, and approval or ratification of the subject by members or by a disinterested majority of directors, or if the transaction is fair. When a director has an interest in a transaction being considered by the board of directors, the director should disclose the conflict before the board of directors takes action on the matter. Upon disclosure by the director, the board should provide a disinterested review of the matter.

   In the event of litigation, the non-disclosing director, and, in some instances, even the disinterested directors who supported the transaction will have the burden of proving fairness. As a practical matter, a non-disclosing director exposes him or herself and the board to substantial risks, including political risk, in such an undisclosed conflict.

   The Business Judgment Rule (described above) will not shield a non-disclosing director or an unreasonably uninformed director from liability. Disclosure enables the other members of the board to evaluate the proposed transaction not merely in terms of fairness, but also for its impact on the image of the association. Generally, the disclosure should include the existence of such interest and its nature (e.g., those arising from financial or family relationships, or professional or business affiliations, etc.) and should be made before any action is taken by the board concerning the matter. The director may consider it prudent to be absent from the part of the meeting when the matter is being discussed, except when his or her input or information may be needed.

   A director having a conflict should record his or her absence from discussion and abstention from any vote relating to the subject of the conflict.

In some cases a director may have an interest in a transaction but be unable, because of duties running to others, to disclose the nature of the interest. In such a case, the director should at least state that such an interest exists, consider leaving the meeting, or at least abstain from the discussion and not vote thereon.

In the rare instance, where the conflicting interest presents so difficult a problem that even the above measures are impossible, the director should consider resigning.

In addition, an interested director should be aware that appropriate voting and quorum requirements must be met. In Colorado, a director, even if interested, may be counted for the purpose of determining the presence of a quorum.

A board of directors that discovers that it has acted upon a proposal in ignorance of an undisclosed interest should promptly reexamine the issue, with an appropriate record of such scrutiny.

In some cases a board may legitimately choose to deal with an inside supplier of goods and services because of greater familiarity with the supplier's reliability.

Contracting with a director providing services may result in extra benefits for the association, the association records must show that the best interests of the association were the overriding consideration in deciding to use such a supplier.

7) DUTY OF CONFIDENTIALITY

A director should not, in the regular course of business, disclose information about the association's activities unless they are already known by the members or are part of the association's records.

In the normal course of business, a director should treat as confidential all matters involving the association until there has been general public disclosure or unless the information is a matter of public record (i.e., reported in the minutes) or common knowledge.

An individual director is not a spokesperson for the association and thus disclosure to the members or public, of association activities, should be made only through the association's designated spokesperson, usually the President or manager.

A presumption of confidential treatment should apply to all current information about legitimate board or association activities.

8) DUTY TO AVOID INTENTIONAL MISCONDUCT AND KNOWING VIOLATIONS OF LAW

Directors have a duty to avoid deliberate wrongdoing, misbehavior and known violations of law.

9) DUTY TO AVOID UNLAWFUL DISTRIBUTIONS OF ASSOCIATION ASSETS

The Revised Colorado Nonprofit Corporation Act imposes personal liability on a director who votes for or assents to a distribution of association assets made in violation of the Nonprofit Act or the association's Articles of Incorporation.

10) DUTY TO AVOID LOANS FROM THE ASSOCIATION TO A DIRECTOR

The Nonprofit Act does not allow a director to receive a loan from the association.

11) DUTY TO NOT APPROPRIATE A CORPORATE OPPORTUNITY

A corporate opportunity is a business opportunity which becomes known to a director or officer, due to his/her position within the association. In essence, the opportunity or knowledge belongs to the association, and directors owe a duty not to use that opportunity or knowledge for their own benefit.

The association may have the right to damages for improper appropriation or use of the opportunity by a director. The theory is that the director who takes that opportunity holds it in "constructive trust" for the association.

The association may obtain a court order to prevent use of the knowledge or opportunity.

Or, angry members may bring their own lawsuit for their benefit in what is called a derivative action.

Insider misappropriation may also be criminal theft.

12) DUTY TO ACT WITHIN THE SCOPE OF AUTHORITY

Directors owe a duty to their associations and to their members to perform their duties in accordance with the authority granted to them by statute and in their governing documents. If directors exceed this authority, and damage results, the directors may be personally liable for their unauthorized actions.

13) CONCLUSION

a) Assess the Risk. Volunteer directors recognize that they face risk and exposures, just like other business corporation directors.

Those who provide professional advice and services to associations should focus attention on the consequences of casually or unmindfully undertaking and serving as a director of a community association. Directors and potential directors should be educated on duties, best practices and risk management to limit liability. By receiving and acting on this advice, directors can effectively serve their communities without risking their personal assets.

If directors cannot serve relatively free from claims, they should resign and it is not too extreme to suggest that the community association, as a form of real estate development and ownership, will be at risk.

b) Qualified and capable board members are needed to govern vibrant and effective owner associations. The roles of community associations and the directors that govern these associations are so important that capable persons must be attracted to be directors.

i) The Developer Control Period. The period of developer control is critical to the initial health of a community association. Developers should make diligent efforts to attract good candidates for appointment to the boards of the associations in communities they create.

ii) After Developer Control. After transition, associations must continue to attract capable owners to be directors. The risks of failure to do so are loss of value in the community and division among the members.

c) Efforts should be made and procedures implemented to limit hostility toward board members.

Service on the board of directors of a community association should add to community spirit and property values of the members.

Directors should not have to lose sleep, lose friends, or get sued.

Sometimes it is inevitable that relationships between directors and other members of the community will become adversarial, whether because of the economy, personal circumstances, or due to the manner in which homes and properties are being managed.

Establishing effective procedures in advance to address these situations can limit the disruption of board meetings by angry members, limit personal confrontations and reduce the likelihood of lawsuits.

d) The Final Word – Be informed and stay informed on duties and how to limit liability. A major concern that inhibits or prevents candidates from serving on the board is their concern that they will be exposed to lawsuits and other claims. A good way to address liability concerns of board member candidates is to educate potential directors on their duties and how to protect themselves from liability.