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COMMUNITY ASSOCIATIONS AND NOT-FOR-PROFIT BOARD MEMBER LIABILITY

You've just been elected to the board of directors of your homeowners' association. The months of diligently attending meetings, talking to neighbors, and educating yourself on the issues important to the neighborhood has paid off. Many newly-minted board members accept the challenge with a working understanding of processes and difficulties boards face while governing, and hopefully improving, their neighborhoods. What many fail to realize, however, is that if something goes wrong, or the board gets complacent, it can possibly spell serious trouble for the individuals who sit on the board, and possibly the association as a whole. This article will attempt to shed light on some potential areas where a board of an association could find itself in difficulty, as well as offer some preemptive measures the board can employ to ensure the protection and smooth operation of not only the board itself, but also the association at large. Before we begin to discuss common areas of pitfall, it helps to have a clear understanding of where the board gets its authority to govern the association.

- Sources of Authority -

Community associations are governed in part by the Illinois General Not for Profit Corporation Act of 1986, 805 ILCS 105/101.01 *et seq*. (the "Act").[1] Like all corporations, a community association – such as a homeowners', townhome or condominium association – acts through its board of directors.[2] In order to encourage members of a community association to participate in the capacity of a director, the Illinois General Assembly enacted, as a part of the Act, a provision that shields volunteer directors of a not-for-profit corporation from individual

[1] Community associations are also governed by one of two substantive acts: condominiums are governed by the Condominium Property Act, 765 ILCS 605/1 *et seq*.; townhomes, villas, single-family homes, and master associations are governed by the Common Interest Community Association Act, 765 ILCS 160/1-1 *et seq*.

[2] The Condominium Property Act refers to a board of managers. This article will refer to the more general term – board of directors.

liability for damages resulting from the exercise of judgment or discretion in the performance of the director's duties and responsibilities. In a general sense, this "liability shield" is what protects board members from suit. Nevertheless, as we will see, that shield is not absolute.

In order to invoke the liability shield, the following prerequisites must be met: (i) the director must serve without compensation (other than reimbursement for actual expenses); (ii) the community association must be incorporated in Illinois as a not-for-profit corporation under the Act; (iii) the community association must be exempt, or qualified for exemption, from taxation pursuant to Section 501(c) of the Internal Revenue Code of 1986; and (iv) the director's acts or omissions must not involve "willful or wanton conduct."[3] The Act previously defined willful or wanton conduct as "a course of action which shows an actual or deliberate intention to cause harm or which, if not intentional, shows an utter indifference or conscious disregard for the safety of others or their property."[4]

The Act's liability shield is at times mirrored or expanded upon in the association's governing documents. The governing documents include the articles of incorporation, bylaws, and declaration of covenants and restrictions. The articles of incorporation create and register the community association with the state and permit the community association to exercise the powers of a not-for-profit corporation; the bylaws set forth the structural and procedural framework for the community association; and the declaration creates and defines the community association and is recorded against the entire community property so that all (current and future) property owners are bound by its provisions (i.e., the declaration "runs with the land" and is found in the chain of title).

Generally speaking, the bylaws and declaration are documents that can and should contain language that exculpates – or frees from blame – directors from liability emanating from certain thresholds of conduct. Thus, the bylaws and declaration could provide, for example, that directors will not be liable for any mistake of judgment or for any other acts or omissions of any nature except for acts or omissions found by a court to constitute gross negligence or fraud. 805 ILCS 105/108.75(a); *see, e.g., Adams v. Meyers*, 620 N.E.2d 1298, 1305 (1st Dist. 1993); s*ee also Kelley v. Astor Investors, Inc.*, 462 N.E.2d 996, 999 (2nd Dist. 1984) (declaration limit on liability of directors to acts of willful misconduct).[5] Such exculpation clauses, though helpful, should not promote a carefree attitude toward discharging one's fiduciary duties.

- Duties & Potential Liability -

Having seen the potential boards face with respect to adhering to the responsibilities placed upon them by their various sources of authority, it is important that each board member be familiar with various tools which can be employed to protect that board member, the board itself, and the association at large. Paramount to all others, however, is the need for the board to educate itself on the rules and duties that govern how the board and association operate.

The directors of a community association are charged with executing their duties and responsibilities to the association and its members with the care of a fiduciary.[6] A fiduciary is

[3] *See generally,* 805 ILCS 105/108.70.

[4] This definition of "willful or wanton conduct" was originally codified as 805 ILCS 105/108.70(d), but was since eliminated from the Act with the passage of P.A. 95-342, effective January 1, 2008. Nonetheless, the thrust of the originally codified definition remains instructive.

[5] On the continuum of severity, negligence is surpassed by gross negligence, and both are surpassed by both fraud and willful or wanton conduct.

[6] *See, e.g.,* 765 ILCS 605/18.4(a).

defined as "[a] person who is required to act for the benefit of another person on all matters within the scope of their relationship" and "[o]ne who must exercise a high standard of care in managing another's money or property."[7] More specifically, directors (and officers) of a community association owe the duties of good faith, care, and loyalty to the association and its members. Furthermore, directors (and officers) are prohibited from, for example: (i) misappropriating corporate assets; (ii) engaging in self-dealing; (iii) commingling personal and corporate assets; (iv) failing to disclose conflicts of interest; and (v) usurping corporate opportunities (which is a fancy way of saying seizing, for personal benefit, opportunities otherwise available to the corporate entity).

The liability based on action of the board falls into two distinct categories: (i) liability of the individual director themselves; and (ii) general board liability, for which the association at large is responsible. While the Act shields a volunteer director of a nonprofit from personal liability, that shield does not apply to willful and wanton torts of the director (which may include breach of fiduciary duty owed to the association's members, as discussed above).[8] A director runs afoul of the protection of the statute where "fraud, bad faith, or self-dealing in the usual sense of personal profit or betterment" to the director exists.[9] Generally, if a director realizes personal gain in a manner that is not shared among the association members at large, that director may lose the protection of the business judgment rule and be exposed to liability for their actions, as they may be deemed as having breached their fiduciary duty. This concept can be evidenced no more clearly than in cases where a director uses their position to influence the association for their individual benefit. In the case of *Mission Hills Condominium Ass'n M-1 v. Corley*, the court ruled that association members had standing to sue a director who funneled association contracts, such as snow removal, maintenance and landscaping, to entities affiliated with the director.[10] Plaintiffs in *Mission Hills* alleged that over four years, the association was billed $750,000 in excess of lower and more competent bids for similar services.

Generally speaking, if a director's action gives rise to a tort claim, that director's liability is determined on an individual basis.[11] However, if a claim of wrongdoing is not based upon improper tortious acts of the individual director, the individual director is shielded from liability, and the association then defends the claim.

One of the most important legal protections afforded to an association and its board is that of the "Business Judgment Rule." Absent willful and wanton tortious conduct by individual directors, the business judgment rule creates a rebuttable presumption that each director's decisions are made on an informed basis, in good faith and with the best interests of the corporation at heart.[12] While a well-grounded principle in the business world, Illinois courts have expanded the rule's applicability to associations as well.[13] Therefore, the business judgment rule would protect a director from personal liability if he or she has performed

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[7] BLACK'S LAW DICTIONARY 658 (8th ed. 2004).
[8] 805 ILCS 105/108.70(b-5).
[9] *Sherman v. Ryan*, 392 Ill.App.3d 712, 722, 911 N.E.2d 378, 389 (1st Dist. 2009).
[10] *Mission Hills Condominium Ass'n M-1 v. Corley*, 570 F.Supp. 453, 459 (N.D. Ill. 1983).
[11] *Willmschen v. Trinity Lakes Improvement Ass'n*, 362 Ill.App.3d 546, 551-552, 840 N.E.2d 1275, 1280 (2nd Dist. 2005).
[12] *Ferris Elevator Co. v. Neffco Inc.*, 285 Ill.App3d 350, 354, 674 N.E.2d 449 (3rd Dist. 1996).
[13] *Amoco Realty Co. v. Montalbano*, 133 Ill.App.3d 327, 332, 478 N.E.2d 860, 864 (2nd Dist. 1985).

objectively and even-handedly in legitimate furtherance of association objectives, even in cases where the director's judgment is ultimately in error.[14]

An important distinction to be made is that the business judgment rule only offers protection to a *disinterested* director.[15] The concept of a disinterested director within the context of an association board may not seem as straightforward as it otherwise would be in the corporate world. By the very nature of being an owner within the association, a director on homeowners, condominium or townhome boards has an inherent personal interest which often eclipses that of many corporate board members in decisions made by the board.

Does this mean that a director of a community association cannot vote on issues before the board that a director believes to be in their self-interest? Of course, it does not. Properly discharging their fiduciary duty to the association's members, by avoiding self-dealing and conflicts of interest, protects the individual director from personal liability. Absent these, or other tortious acts undertaken by the director, Illinois' liability shield continues to protect the individual director from personal liability. The business judgment rule further protects the board and the association at large from actions of the board of directors, provided informed decisions for proper purposes are made by the board and its members.

While the business judgment rule protects an association from mistakes and misjudgments by its board, it does require that boards observe the formalities contained in their governing documents in making its decisions. Proper governing documents will set forth protocol for: (i) noticing members of the association and the board of scheduled meetings; (ii) requirements for quorum at such meetings, such that any votes taken will be valid; and (iii) percentages required for passing votes on various items business of the association, and who may vote on such items. Well-drafted governing documents may even compel a director to abstain from casting a vote on matters where the director has a real or perceived conflict of interest.

By following the protocol for decision-making prescribed in the association's governing documents, directors further insulate themselves and the association from liability for the board's decisions. However, violating the governing documents of an association by the board may give rise to a cause of action against the association.[16] In *Wolinsky*, failure to hold a proper vote on a purchase by the association gave the plaintiff standing for her suit against the association. Going a step further, Illinois courts have noted that "[a] condominium board of managers' proper exercise of its fiduciary duties requires strict compliance with [the] bylaws."[17] In other words, failing to strictly comply with the association's bylaws amounts to a breach of fiduciary duty. Following the prescribed formalities of the association and statutes serves to ward off many potential suits, and also assists in developing the presumption of transparency, fairness and proper purpose of board actions. The court in *Litvak* also noted that the board seemed to lack sound records and minutes regarding the adoption and approval of the budget in question.[18]

Despite even the best "by the book" approach taken by many boards, following its formalities merely suggests proper action on the part of the board. The *Litvak* case demonstrates the constant need for the board to comply with the governing documents and to abide by sound corporate practices, with an emphasis on documentation and record keeping. Following sound

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[14] *Bd. of Dirs. of 175 E. Del. Place Homeowners Ass'n v. Hinojosa*, 287 Ill.App.3d 886, , 679 N.E.2d 407, 410 (1st Dist. 1997).
[15] *See Aronson v. Lewis*, 473 A.2d 804, 814 (Del. 1984).
[16] *Wolinsky v. Kadison*, 114 Ill.App3d 527, 534, 449 N.E.2d 151, 157 (1st Dist. 1983).
[17] *Litvak v. 155 Harbor Drive Condominium Ass'n, Inc.*, 244 Ill.App3d 220, 226, 614 N.E.2d, 190, 195 (1st Dist. 1993).
[18] *Id*.

corporate practices should help enable the board of directors to take advantage of the liability shield provided by the Act as well as those of the business judgment rule.

Often when something goes awry within an association, individual association members are quick to accuse the board of having failed to prevent the wrong from occurring. If a board finds itself unable to justify its decisions, it may be hard for the board to invoke the business judgment rule's protection and claim it acted on an informed basis. In *Davis v. Dyson*, it was discovered that the association's property manager had allegedly embezzled upwards of $500,000 of the association's funds.[19] Association members claimed that members of the board made uninformed decisions in hiring the manager, as well as in failing to periodically review association financial reports. In order for the business judgment rule to afford protection to the board, and ultimately the association as a whole, directors must inform themselves of facts necessary to make informed decisions.[20] Simply holding proper meetings and votes would not protect the association in these cases, and further highlights the need for documentation of information the board considers while making its decisions. In *Davis*, had the board been able to illustrate a reasoned approach to reviewing bids for property managers, as well as keeping meeting minutes which included reports of the treasurer (evidencing proper oversight), it is possible that the association would have been protected by the business judgment rule. Specifically, this means that the board should formally meet whenever an important issue is to be decided, and the board should maintain thorough records and minutes of all meetings to document the decisions made by the board.

- The Association's Team and the Management Company -

Nevertheless, as a volunteer board, it is often impossible to inquire into the finer details of every decision faced by a community of often hundreds of homes. Armed with the knowledge of the foregoing duties and potential liability, the board of directors should delegate tasks to, and rely upon the services of, its team. This "team" – namely, the management company, accountant, attorney, and insurance agent – should aid the board in carrying out the business of the community association. Thus, it is important for the board to surround itself with a quality team, not only to carry out the business of the community association in an efficient and workmanlike manner, but to also mitigate the likelihood of incurring liability – either for the community association or the board of directors, individually.

The management company is a crucial team member for a community association, and especially so for the board of directors. It is of paramount importance to procure the services of a quality management company, both for the purpose of accomplishing the day-to-day tasks of administering the association, but also for the purpose of mitigating the risk of potential liability for the association and its board. On July 1, 2010, the Illinois General Assembly passed the Community Association Manager Licensing and Disciplinary Act.[21] The purpose of the legislation is to more closely regulate the management function of community associations by requiring the "community association manager" (defined in the statute) to be licensed (i.e., meet a minimum set of qualifications needed to manage community associations). The statue also sets forth ethical and professional standards for "community association managers," and also creates various disciplinary procedures to police the profession. It is likely that the passage of this act

[19] *Davis v. Dyson*, 387 Ill.App.3d 676, 678, 900 N.E.2d 698, 701 (1st Dist. 2008).
[20] *Stamp v. Touche Ross & Co.*, 263 Ill.App3d 1010, 1015, 636 N.E.2d 616, 621 (1st Dist. 1993).
[21] 225 ILCS 427/1 *et seq*.

will serve to consolidate the property management industry into fewer, albeit more effective and skilled, management companies.

A community association (the principal) grants its management company (the agent) authority to carry out much of the day-to-day business of the community association. This grant of authority is contractual in nature, and brings agency law concepts into play. Under agency law, generally speaking, a principal is liable for the actions of its agent. This means that the community association – through its board – often remains liable for the actions of the management company. In rare cases, this liability flows back to the directors, individually. Recall *Davis*, where the property manager was accused of embezzling association funds. The court found that not only did the business judgment rule not protect the board, but certain board members might have breached their fiduciary duties.[22] The defendant directors' motion to dismiss was denied, and thus a suit was permitted to proceed against the directors, individually.[23] The *Davis* case illustrates the need for a quality management company, but more importantly, it illustrates the need for the board to remain diligent in overseeing the affairs of its team members and the association, generally.

It is important to note that the management company contract – the contract between the community association and the management company, wherein the community association authorizes the management company to act on the community association's behalf – raises two special considerations: (i) indemnification and (ii) fidelity bonds.

It is not an overstatement to say that every management company contract contains a provision that requires the community association to indemnify the management company for its actions pursuant to the community association's grant of authority. This means that the association is obligated to indemnify (or reimburse) the management company for "losses" incurred pursuant to the management contract. In other words, if the management company is sued for an action taken pursuant to the management contract, the association would have to pay for the management company's attorneys' fees, costs, and damages (or settlement, as the case may be).

A second issue arising out of the management contract concerns the association's statutory obligation to procure a fidelity bond.[24] A community association is required to maintain a fidelity bond for all who control or disburse the funds of the association.[25] Because the management company falls into this category, the management company must be covered under a fidelity bond.[26] The amount of the fidelity bond should be for the full amount of the community association's funds and reserves, within the control of the person or entity, for that year.[27] Under the management contract, the association is responsible for paying the premiums associated with the management company's fidelity bond.

- Suggested Best Practices for Boards -

Although generally not mandated to do so by Illinois or Federal law, nonprofit corporations (such as the community associations discussed in this article) can benefit greatly

[22] *Davis*, 387 Ill.App.3d at 702.
[23] *Id*.
[24] *See, e.g.,* 765 ILCS 605/12(a)(3) under the Condominium Property Act.
[25] *See* 765 ILCS 605/12(a)(3)(A).
[26] *See* 765 ILCS 605/12(a)(3)(B).
[27] *See* 765 ILCS 605/12(a)(3)(C).

from applying certain provisions of the Pubic Accounting Reform and Investor Protection Act, better known as Sarbanes Oxley.[28, 29] Under Sarbanes Oxley, the CEO and CFO of public corporations must personally certify financial statements of the company. As a nonprofit entity, associations may require their president and treasurer, or the board as a whole, to review financial statements of the association, sign off that they understand them and attest to their accuracy. Likewise the board or certain officers should review the association's IRS Form 990 before filing, and ensure its accuracy. Sarbanes Oxley also mandates disclosure of certain financial data, much of which is not relevant to a nonprofit organization such as an association. However, good practice for a community association is to make its financial data, including tax returns, annual financial statements and IRS Form 990 readily available for its members' review.

Best practices of a board may also include requesting an annual review meeting with the association's attorney and insurance agent. As association and nonprofit law continuously changes, new cases are heard, and new challenges present themselves, it is essential that an association's attorney provide an annual review to ensure that: (i) the association's governing documents are up to date, and adequately protect the association; (ii) policies and procedures are reviewed and implemented; and (iii) any challenges foreseen by the board during the upcoming year are prepared for in advance. In the present legal environment, it is not unreasonable for an association to expect this service as a complimentary value-added feature of their on-going legal representation.

While much of the board's focus is logically spent on mitigating risks that give rise to liability, preparation should be made for instances where the association finds itself nevertheless defending a claim. Another avenue of protection, or safety net, for the board of directors is through what is colloquially known as "D&O insurance" – D&O referring to directors and officers.[30] Recall that the business of any corporation is carried out through its board of directors and officers; both groups are charged with certain fiduciary duties that are owed to the corporation and its members or shareholders (and thus a director or officer can incur personal liability for breaching those fiduciary duties). D&O insurance can hedge against, and mitigate the exposure to, potential individual liability to those serving in the capacity as a director or officer, should a claim against the board's actions ever arise.

At its best, D&O insurance would cover both the legal defense (including attorneys' fees and costs) and any liability imposed on the insured (or amount paid in settlement). However, it is important to note that not all types of conduct are "insurable" or "covered" risks under D&O insurance. For example, if a director engaged in conduct that violated an individual's civil rights, D&O insurance would not cover that conduct (or any subsequent liability imposed on the director). With that in mind, directors and officers should also be aware of the particular language and scope of the D&O coverage for another reason: the insurer may opt to defend the actor under a "reservation of rights." In this scenario, the insurer would provide the legal defense for the acts or omissions of the director or officer, but the director or officer would be responsible for any liability imposed on the director or officer. It is always a good idea to have the insurance agent periodically explain the scope of the coverage (and any changes or

[28] 15 U.S.C. § 7201 *et seq*.
[29] Provisions of Sarbanes Oxley regarding document preservation and whistleblower protection do apply to nonprofit organizations. 15 U.S.C. 7201 §§ 802, 806. Certain states, including Iowa, have enacted Sarbanes Oxley-type legislation for nonprofit organizations.
[30] *See* 805 ILCS 105/108.75(g) and 765 ILCS 605/12(a)(3)(D).

modifications made thereto), as well as answer any questions the association or board of directors may have.

As even claims which ultimately prove meritless can have a substantial negative impact on an association's finances, a prepared association may elect to create a "loss reserve" in its capital account. This loss reserve may be held in the same account as the association's general reserve fund, however monies earmarked for losses should not be used for typical reserve fund functions, such as replacing roofs or paving common drives. Loss reserve funds would be earmarked for cases where the association is held liable for uninsurable risks or where the association cannot recover attorneys' fees, such as defending a merit-less claim. All too often, such unforeseen and unbudgeted losses are paid out of the association's capital or operating accounts, creating significant delay in association repairs or services, and resulting in hefty special assessments to members.

As you can see, there are numerous legal dynamics and potentials for liability that an association board should spend time and educate itself on. Further, we hope we have been able to provide some suggestions on additional methods a board can employ to protect itself and the association it represents. If you have any additional questions, please feel free to contact us.