A Case For Reasonableness

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> *The essence of Government is power; and power, lodged as it must be in human hands, will ever be liable to abuse.*[1]

In 2007, the Arizona Court of Appeals issued a published decision appearing to be a victory for homeowners residing within a homeowners' association ("HOA"). In *Tierra Ranchos Homeowners Association v. Kitchukov*,[2] Arizona joined several other states in holding that HOA discretionary decisions are not entitled to protection under the business judgment rule. Unlike the traditional corporate decision standards, HOA decisions are not entitled to a presumption of good faith. As such, any homeowner attempting to challenge an HOA decision does not have to meet the heavy burden of overcoming the presumption of the business judgment rule.[3] The homeowner need only establish that the HOA's decision was unreasonable.[4]

Settling the dispute about the business judgment rule in the context of HOAs was the end of the *Tierra Ranchos* inquiry. *Tierra Ranchos* did

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1 James Madison, Speech before the Virginia State Constitutional Convention (Dec. 1, 1829), *available at* http://www.loc.gov/loc/walls/madison.html (last visited Mar. 14, 2011).

2 Tierra Ranchos Homeowners Ass'n v. Kitchukov, 165 P.3d 173, 179 (Ariz. Ct. App. 2007).

3 The business judgment rule "precludes judicial inquiry into actions taken by a director in good faith and in the exercise of honest judgment in the legitimate and lawful furtherance of a corporate purpose." Schoen v. Schoen, 804 P.2d 787, 794 (Ariz. Ct. App. 1990).

4 *Id.* at 179-180. *See* Restatement (Third) of Prop.: Servitudes § 6.13 (2000).

not discuss potential claims homeowners may have against their HOAs or their HOAs' directors, nor did it discuss the duties owed by the HOAs and their directors.[5] The *Tierra Ranchos* court limited its holding to the standard a court should apply when evaluating discretionary HOA decisions.[6] However, practitioners in Arizona have misinterpreted *Tierra Ranchos* by arguing the decision established that neither the HOA nor its directors owe fiduciary duties to anyone–not to the community as a whole, not to the members of the HOA–to nobody. Instead, the HOA attorneys argue that HOAs and their directors need only act reasonably. Logically, if a director need only act reasonably, he or she only owes a duty of "reasonableness."

The "reasonableness" argument is undeniably appealing to the HOA attorney. Anytime a director or the HOA itself is sued for breach of fiduciary duty, the HOA attorney argues that no such duty exists and that the claim, therefore, fails as a matter of law. If that is the case, however, what is it for which a homeowner can sue? Unreasonableness? Is that a cause of action? More importantly, why would a director serving on a board that has the power to take someone's home through lien foreclosure have less accountability than a director serving on a board that has the power to do nothing more than make decisions about the value of someone's stock?

While it may seem clear to some that HOAs and their directors owe fiduciary duties to their members, Arizona has never expressly said so. As a result, trial courts reach conflicting conclusions when addressing the HOAs' motions to dismiss breach of fiduciary duty claims asserted by homeowners.[7] Trial courts granting HOAs' motions to dismiss are leaving the homeowners without any recourse against HOAs, despite allegations of significant wrongdoing. Some courts have directed homeowners to assert the "lesser" cause of action for "reasonableness."[8] Other trial courts, denying motions to dismiss, find that *Tierra Ranchos* defined the standard as applied to the duty but not the duty itself, which is fiduciary in nature.[9] The conflicting decisions demonstrate that unless and until the Court of Appeals addresses this issue directly, HOA practitioners on

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[5] *See Tierra Ranchos,* 165 P.3d at 179.

[6] *Id.* at 180 (holding that Arizona will follow the "Restatement approach" when reviewing "discretionary decisions of a community association").

[7] *See* Johnson v. Pointe Cmty. Ass'n, 73 P.3d 616, 620 (2003) (reversing trial court's dismissal of claim for breach of fiduciary duty).

[8] *See, e.g.*, Ponkey v. Winfield Owners Cmty. Ass'n, No. CV 2010-010380 (Ariz. Super. Ct. Nov. 8, 2010).

[9] *See, e.g.*, Chaffin v. N. Manor W. Townhouse Ass'n, No. CV 2010-020343 (Ariz. Super. Ct. Dec. 10, 2010).

both sides of the dispute have no clear answer as to whether HOAs and their directors owe fiduciary duties to their members. This paper examines this issue in detail and demonstrates why HOAs and their directors do in fact owe fiduciary duties to their members.

I. THE "QUASI-GOVERNMENTAL" HOA

Recently, Arizona and the rest of the country have seen a tremendous increase in HOAs. According to the Community Association Institute, the number of HOA communities in the U.S. increased twentyfold since 1970.[10] In 2010, research results indicated over 309,600 HOAs (or similar associations, such as condominium associations) existed in the U.S.[11] Approximately twenty percent of the value of all U.S. residential real estate is comprised of HOA housing.[12] Indeed, it is now "common knowledge that much of the new housing developed in recent years–including single-family detached dwellings–is subject to [a Declaration of Covenants, Conditions and Restrictions] enforceable by such associations."[13]

The HOA serves to privatize public service functions. HOAs provide services "paralleling in almost every case the powers, duties, and responsibilities of a municipal government."[14] HOA services include "utility services, road maintenance, street and common area lighting, and refuse removal."[15] As such, HOAs are not just non-profit corporations; they are "quasi-governmental" entities subject to heightened relations of trust and confidence with their members.[16]

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[10] *Industry Data*, CMTY. ASS'N'S INST., http://www.caionline.org/info/research/Pages/default.aspx (last visited Mar. 14, 2011).

[11] *Id.*

[12] *2009 National Research*, FOUND. FOR CMTY. ASS'N RESEARCH, http://www.cairf.org/research/survey_homeowner.aspx (last visited Mar. 14, 2011).

[13] Duffey v. Superior Court, 4 Cal. Rptr. 2d 334, 340 (Ct. App. 1992).

[14] Villa Milano Homeowners Ass'n v. Il Davorge, 102 Cal. Rptr. 2d 1, 12 (Ct. App. 2000).

[15] *Id.*

[16] Cohen v. Kite Hill Cmty. Ass'n, 191 Cal. Rptr. 209 (Ct. App. 1983); *accord* Chantiles v. Lake Forest II Master Homeowners Ass'n, 345 Cal. Rptr. 2d 1, 5 (Ct. App. 1995) (holding that "the homeowners' association functions as a second municipal government, regulating many aspects of their daily lives"); Woodward v. Bd. of Dirs. of Tamarron Ass'n of Condo. Owners, 155 P.3d 621, 624 (Colo. App. 2007) (holding that HOAs owe fiduciary duties to their members because of "the quasi-governmental functions they serve, and the impact on value and enjoyment that can result from the failure to enforce covenants) (citations omitted); Terre Du Lac Ass'n v. Terre Du Lac, Inc., 737 S.W.2d 206, 215 (Mo. Ct. App. 1987) (holding HOAs have "two distinct roles . . . managerial or service-oriented functions, and quasi-governmental or regulatory functions") (citations omitted); Beaver Lake Ass'n v. Beaver Lake Corp., 264 N.W.2d 871, 875 (Neb. 1978) (holding that HOAs

The powerful nature of the HOA is perhaps most evident by its ability to foreclose upon the member's home. Most Covenants, Conditions, and Restrictions ("CC&Rs") regulating HOA communities require members to pay assessments to the HOA. The collection of assessments, in some HOAs, creates an operational budget "on par with small cities and towns."[17] Regardless of the size of the HOA, in nearly every case it has the power to foreclose on a member's home if assessments are past due. In Arizona, this power is codified,[18] which allows for foreclosure if assessments are unpaid for at least one year or if the unpaid amount totals at least $1,200.

The power to take one's home is certainly significant, but it is not the end of the inquiry into the power of the HOA. The HOA can regulate the size of the home, the color it is painted, the type of roofing, the building materials utilized, and even the ability of an owner to have a swing set in his backyard.[19] In most HOA communities, a homeowner must get permission from the HOA before initiating *any* exterior changes to the home. Rather than enjoying the home as his castle, an HOA resident must ask, "mother, may I?" before doing anything that his neighbors can see.

These characteristics separate HOAs from traditional business corporations. As the Restatement of Property explains, a homeowners' association is distinctly different from an ordinary business corporation, such that traditional corporate law, including the presumption of good faith provided by the business judgment rule, is inapplicable.[20] The Restatement identifies three major differences between traditional corporations and HOAs, noting that these differences create the need for *greater* judicial review.[21] First, "the stakes of the association members are generally much higher than those of shareholders in business corporations."[22] The

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are characterized by "quasi-municipal functions"); Verna v. Links at Valleybrook Neighborhood Ass'n, 852 A.2d 202, 214 (N.J. Super. Ct. App. Div. 2004) (holding that HOAs function "as a second municipal government") (citations omitted).

17 *Duffey*, 4 Cal. Rptr. 2d at 334.

18 ARIZ. REV. STAT. ANN. § 33-1807 (2006); ARIZ. REV. STAT. ANN § 33-1256 (2006).

19 The exact nature of the HOA's power will depend on the CC&Rs applicable to each particular community. ARIZ. REV. STAT. ANN. § 33-440 (2008). For example, see *The Declaration of Covenants, Conditions and Restrictions for Desert Highlands*, (Maricopa County Recorder Recording No. 19830007878, Jan. 6, 1983), *available at* http://156.42.40.50/UnOfficialDocs/pdf/19830007878.pdf; and *Declaration of Covenants, Conditions and Restrictions for Biltmore-Greens III*, (Maricopa County Recorder Recording No. 19800162341 May 16, 1980), *available at* http://156.42.40.50/UnOfficialDocs/pdf/19800162341.pdf.

20 *See* RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 6.13 cmt. b (2000).

21 *Id.*

22 *Id.*

investment for a shareholder is only financial, while the investment for a member of an HOA is that member's home, which is "often the largest single asset the member owns, and which has personal and social significance far beyond the monetary value of the asset."[23] Second, a homeowners' association has much more power over the individual member than an ordinary business corporation, as explained above.[24] Third, an individual's home cannot be sold as easily as shares of stock.[25] Shareholders enjoy the ability to sell stock in a company that no longer supports their ideals, whereas HOA members may be effectively stuck with their "stock" for months or years after ideals diverge. These significant differences strengthen the basis for the need of a fiduciary duty owed to the individual members, which both the directors and the entity itself owe.

When considering the differences between the HOA and the traditional corporation, the logic of the *Tierra Ranchos* decision becomes abundantly clear. The HOA should not be held to a lesser standard than that of a traditional corporation. To the contrary, HOA members should be able to challenge their HOAs without having to overcome the presumption of good faith offered by the business judgment rule in traditional corporate law. To hold otherwise would leave the homeowner without any legitimate remedy for what could be a substantial claim. A California supreme court justice explained that "because legal challenges to their authority remain severely curtailed, HOAs may infringe upon the unfettered enjoyment of one's property without justifying their actions or even according individuals a modicum of due process."[26] A cause of action for breach of fiduciary duty is a deterrent for the homeowner to prevent an HOA from abusing its power.

II. The Special Relationship Between the HOA and Its Members

The Restatement sections 6.13[27] and 6.14[28] set forth specific duties that are owed by both homeowners' associations and their directors. These duties are substantially similar to the fiduciary duties of loyalty, good faith, and care imposed upon directors and officers of any corpora-

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23 *Id.*

24 *Id.*

25 *Id.*

26 Armand Arabian, *Condos, Cats, and CC&Rs: Invasion of the Castle Common*, 23 Pepp. L. Rev. 1, 21 (1995).

27 Restatement (Third) of Prop.: Servitudes § 6.13 (2000).

28 *Id.* at § 6.14 (2000).

tion.[29] The Restatement specifically states that the position of the director or officer of a community association "is close[ ] to that of a director of a non-profit association or director of a closely-held corporation."[30]

The non-profit corporate status of the HOA should, in itself, establish that the entity and its directors owe fiduciary duties. In Arizona, it is well settled that directors for non-profit corporations owe fiduciary duties to their members. In *Hatch v. Emery*, the Court of Appeals held that "the directors or trustees of a corporation whether it be for profit or non-profit are in a fiduciary relationship with the stockholders or members of that corporation."[31] Similarly, in *Atkinson v. Marquart*, the Arizona Supreme Court held that "a director of a corporation owes a fiduciary duty to the corporation and its stockholders . . .[and t]his duty is in the nature of a trust relationship requiring a high degree of care on the part of the director."[32] Why would the non-profit corporation HOA be treated any differently? Because it has *more* power over its members? Therein lies the only difference between the HOA and the non-profit corporation; yet, HOA practitioners argue the HOA should be held to a lesser duty.

The traditional corporation, acting through its directors, does nothing more than manage an individual's financial investment: the stock. However, it is the simple fact that these directors manage the financial affairs of their stockholders that provide the basis for the fiduciary duty. In determining whether one stands in a fiduciary relationship with another, the Arizona Court of Appeals has stated: "More often *a fiduciary is a person who holds property or things of value for another*–a trustee, executor, receiver, conservator or *someone who acts in a representative capacity for another in dealing with the property of the other.*"[33]

The HOA and its directors do much more than simply manage the members' financial investments. These directors collect assessments from their members and are entrusted by their members to spend the assess-

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[29] *See, e.g.*, Master Records, Inc. v. Backman, 652 P.2d 1017, 1020 (Ariz. 1982) (holding that corporate director owes fiduciary duty of good faith to corporation and shareholders); Shoen v. Shoen, 804 P.2d 787, 794 (Ariz. Ct. App. 1990) (holding that corporate director owes fiduciary duty of care and loyalty to corporation and shareholders).

[30] RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 6.14 cmt. a (2000).

[31] Hatch v. Emery, 400 P.2d 349, 353 (Ariz. Ct. App. 1965).

[32] Atkinson v. Marquart, 541 P.2d 556, 558 (Ariz. 1975) (citations omitted).

[33] Standard Chartered PLC v. Price Waterhouse, 945 P.2d 317, 334 (Ariz. Ct. App. 1996) (quoting Franklin Supply Co. v. Tolman, 454 F.2d 1059, 1065 (9th Cir. 1971)) (emphasis added); *see also* RESTATEMENT (FIRST) OF CONTRACTS § 472 cmt. c (1932) (describing a fiduciary as "any person whose relation with another is such that the latter justifiably expects his welfare to be cared for by the former").

ments collected appropriately. The way in which these directors spend the assessments collected will impact the value of the most significant asset the members have: their homes. If the HOA fails to maintain community common areas, such as a swimming pool, home values will decrease due to dilapidated amenities. If, on the other hand, the HOA ensures common areas are well kept and attractive to potential purchasers, home values will likely increase. This demonstrates that the HOA is entrusted with so much more than mere shares of stock, and the HOA directors actually hold their members' homes in their hands.

The Arizona Court of Appeals implicitly recognized the fiduciary nature of the duty owed by HOA directors in *Divizio v. Kewin Enters., Inc.*[34] In that case, mobile home park lot owners, who owned and managed the common areas, brought an action against the operators of the park for a declaratory judgment related to accounting for future assessments.[35] Owning and managing common areas, and collecting assessments to do so, are the defining characteristics of the HOA community, making the factual similarities of the *Divizio* case to an HOA case substantial. The court held that the managers of the mobile home park common areas were in a fiduciary relationship with the lot owners.[36]

The *Young* decision, upon which the *Divizio* court relied, involved an action by subdivision lot owners against the developer with respect to a fund to maintain common areas.[37] The *Young* court held that where the developer was entitled to collect assessments from the lot owners for an express and limited purpose of maintaining the common areas, "the lot owners necessarily were required to repose confidence and trust in [the developer] and that in carrying out its functions . . . [the developer] was required to exercise fairness and good faith."[38] The *Young* court held that "[t]hese are the hallmarks of a fiduciary relationship."[39] By adopting the holding of *Young*, the Arizona Court of Appeals recognized that where one is entrusted with the money of another, to be used for an express and limited purpose, those individuals stand in a fiduciary relationship.[40] The *Divizio* holding is in accord with the *Standard Chartered*

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34 Divizio v. Kewin Enters. Inc., 666 P.2d 1085, 1088 (Ariz. Ct. App. 1983).

35 *Id.* at 1086.

36 *Id.* at 1088 (citing Young v. Lucas Constr. Co., 454 S.W.2d 638 (Mo. Ct. App. 1970).

37 *Young*, 454 S.W.2d at 639.

38 *Id.* at 642.

39 *Id.* (citations omitted).

40 *Divizio*, 666 P.2d at 1088.

PLC holding that a fiduciary "is a person who holds property or things of value for another" in a representative capacity.[41]

III. THE *TIERRA RANCHOS* HOLDING

Based upon the foregoing, it seems clear that HOA practitioners are simply incorrect when they argue that *Tierra Ranchos* negates the existence of the fiduciary relationship between the HOA, its directors, and its members. To the contrary, the reasonableness standard imposed by *Tierra Ranchos* is exactly the same type of fiduciary standard imposed upon traditional corporate directors. The only difference in an HOA is that the directors do not enjoy the benefit of a presumption of good faith as provided by the business judgment rule. In other words, *Tierra Ranchos* did nothing more than *limit the defenses* available to an HOA director when faced with a breach of fiduciary duty claim.

Section 6.14 of the Restatement charges directors and officers of an association with the duty "to use ordinary care and prudence in performing their functions." The fiduciary duty of care "refers to the responsibility to exercise the care that a reasonably prudent person in a similar position would exercise under similar circumstances."[42] Similarly, a trustee, as a fiduciary to the trustor, is "required to exercise such care and skill as a person of ordinary prudence would exercise with his own property. [The fiduciary is] under a duty to take and keep control of the trust property and to use reasonable care and skill to preserve the trust property."[43] Accordingly, although the fiduciary relationship involves the utmost trust and care because the fiduciary has been entrusted to act on another's behalf, the fiduciary is still only obligated to act with *reasonable* care and is not held to a higher standard of care.[44]

Given that a homeowners' association carries with it a "particularly elevated position of trust because of the many interests it monitors and services it performs,"[45] it is no surprise that the *Tierra Ranchos* court rejected the business judgment rule. Directors in these situations are not

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[41] Standard Chartered PLC v. Price Wterhouse, 945 P.2d 317, 334 (Ariz. Ct. App. 1996).

[42] Schoen v. Shoen, 804 P.2d 787, 794 (Ariz. Ct. App. 1990) (explaining fiduciary duty of care owed by corporate directors).

[43] Ross v. Bartz, 762 P.2d 592, 594 (Ariz. Ct. App. 1988); *see also* Musselman v. Southwinds Realty, Inc., 704 P.2d 814, 817 (Ariz. Ct. App. 1985) (real estate agent "is under a duty to her principal to exercise reasonable care").

[44] *See Musselman*, 704 P.2d at 817 (holding that real estate agent has no duty to obtain the highest and best price for property, but only required to exercise reasonable care in selling property).

[45] Cohen v. Kite Hill Cmty. Ass'n, 191 Cal. Rptr. 209, 216 (Ct. App. 1983).

entitled to a presumption of good faith that a homeowner must overcome, but rather the homeowner need only establish breach of fiduciary duty by showing the director's actions were unreasonable.

The court in *Tierra Ranchos* did not reject this well-established law regarding the fiduciary duties owed by the directors of a homeowners' association. By adopting the Restatement, the court declined to extend the protection of the business judgment rule to homeowners' association directors, making it *easier* for a homeowner to establish breach of fiduciary duty. Associations and their directors can no longer rely on the presumption that their actions were undertaken in good faith. The reasonableness standard articulated by the court in *Tierra Ranchos*, and set forth in the Restatement, is and always has been the standard applicable to fiduciary relationships.

IV. Conclusion

Before the *Tierra Ranchos* decision, HOA practitioners relied on a single case, *Rohde v. Beztak of Arizona, Inc.*,[46] to argue that HOAs do not owe fiduciary duties to their members. In *Rohde*, the Court of Appeals did not evaluate whether the HOA owed a fiduciary duty, but rather, in dicta, noted that the plaintiff in that case did not provide any authority demonstrating that a fiduciary duty was owed. HOA directors were not discussed. In any event, that particular plaintiff's failures cannot be attributed to the state of the law applicable to these issues. As set forth above, there is in fact an abundance of authority demonstrating that the HOA and its directors owe fiduciary duties to the members.

When the Court of Appeals published *Tierra Ranchos*, it adopted the Restatement's approach to evaluating HOA decisions. The Restatement recognizes the existence of the fiduciary duty relationship. Accordingly, it appeared that the debate regarding the meaning of the dicta in the *Rohde* decision was over. Unfortunately, however, the debate has escalated. Trial courts reach conflicting rulings when evaluating these two cases, leaving both the HOA and its members without a clear answer.

It is difficult to imagine that the Court of Appeals intended to impose a lesser duty upon the HOA and its directors than that imposed upon traditional corporations. It defies logic to hold the HOA and its directors to a lesser standard of care in light of the significant power the HOA has over its individual members. However, until an Arizona appellate court decides to speak to this issue directly, the debate will undoubtedly continue.

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46 Rohde v. Beztak of Arizona, Inc., 793 P.2d 140, 145 (Ariz. Ct. App. 1990).