UNDERSTANDING THE “BUSINESS JUDGMENT RULE” THAT OFTEN PROTECTS HOA DIRECTORS AGAINST LIABILITY FOR BAD DECISION MAKIING

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HOA Member Services

The Business Judgment Rule creates a presumption that the decisions made by homeowner’s association directors are based on sound business judgment. Simply put, under the Business Judgment Rule association directors are presumed to have acted in good faith, on an informed basis, and in the honest belief that the action taken was in the best interest of the association. The rule is based on the recognition of the fact that association directors sometimes make decisions that in retrospect were not the “right” decision. Courts recognize that the power to manage the affairs of a corporation, such as a homeowners’ association, is vested in the association’s board of directors and neither a court, nor the association’s members, can substitute their business judgment for the judgment of the association’s board of directors – so long as the directors have acted in good faith and with a view to best interests of the association and all of its members.

The Business Judgment Rule protects directors from personal liability for bad decisions that have resulted in damage or loss to others so long as the directors’ decisions were made in good faith, in a manner that the directors believed were in the best interests of the association, after making a reasonable inquiry into the matter. Thus, courts will generally uphold decisions made by an association’s board of directors so long as the decisions resulted from a good faith effort to further the purposes of the common interest development, are consistent with the association’s governing documents, and are in keeping with public policy. The rule extends to protecting directors from liability when their decision was based on their reliance on information that was prepared by or presented by experts that the directors reasonably believed were reliable and competent.

For the Business Judgment Rule to apply, association directors must make a conscious decision based on a consideration of the facts exercising the judgment that an ordinarily prudent person in a like position would use under similar circumstances. The presumption that directors’ decisions are based on sound business judgment can be rebutted by a factual showing of fraud, bad faith, gross overreaching by the director(s), and acting under a material conflict of interest.

Application of the Business Judgment Rule presupposes that in making their decision, the directors have exercised reasonable diligence. Thus, directors cannot close their eyes as to what is going on in the conduct of the association’s business and be protected against liability for a bad decision because that decision would not have been based on an exercise of sound business judgment. The protections do not extend to directors who choose to remain ignorant and who rely on uninformed beliefs as to the matters surrounding their decisions, or their authority to make those decisions. Furthermore, in exercising their business judgment, association boards cannot ignore the content of the association’s governing documents or applicable laws. Additionally, inaction by the directors that was not the result of a deliberative process will not be protected.

It is important for homeowners association members and management personnel to understand the Business Judgment Rule and its application to the decision making that is made by the directors of a homeowners association. While the rule is frequently applied by courts to protect individual directors against liability for their decision making, that protection is not absolute and under certain circumstances the individual directors can be subjected to personal liability for damages that are caused by their decision making.