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Duty... What Duty?!

Unraveling the Duty of Association Directors and Officers

The legal responsibilities and duties of community association directors and officers can be one of the most misunderstood areas of community association law. Phrases like “fiduciary duty” and “conflict of interest” are often thrown around in connection with describing the responsibility of board members to the association. Unfortunately, however, these terms are often misused and misapplied, both by homeowners and board members alike. This article will debunk some of the more common misconceptions when it comes to the legal standard of duty for association officers and directors.

IT'S ONLY HUMAN TO MAKE MISTAKES . . .

Does that make us liable?

It is reasonable to expect that any group of people that are running a corporation will make mistakes or poor decisions sometimes. When the mistake affects a group of angry homeowners, though, there is often a mistaken expectation that the officers and directors involved will be legally responsible for the outcome. This is not always the case. The Georgia Non-Profit Corporation Code (“Code”), which governs non-profit community

associations, gives directors and officers a specific standard to comply with when handling their duties for the association. These standards are known as the duty of care and the duty of loyalty, and these are the same duties held by all non-profit corporate directors and officers.

Duty of Care

Under Georgia law, directors and officers must discharge their duties in a manner the director/officer believes in good faith to be in the best interest of the corporation and with the care an ordinarily prudent person in a like position would exercise under similar circumstances. To comply with this Duty of Care, directors must:

- Make educated decisions. This means investigating issues, asking appropriate questions, attending meetings, reading the covenants and bylaws, and fairly considering all issues.
- Vote in a manner that the director believes, in good faith, is in the best interest of the corporation.

Duty of Loyalty

Directors and officers must:

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**Individual situations may vary. This document is not intended to use as specific legal advice.*





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- Put the interests of the association above their personal interests.
- Protect the association's money.
- Avoid undisclosed conflicts of interest.
- Avoid competing with the association's interests and opportunities.

If a decision of the board is challenged in some manner, courts generally apply one of the standards of review for board decisions – The Business Judgment Rule, or the Reasonableness Standard.

The Business Judgment Rule requires the board to:

- Use good faith when deciding what is in the best interest of the corporation.
- Use common sense (the care of an ordinarily prudent person).
- Rely on the opinions and recommendations of the professionals around you (attorney, CPAs, managers, engineers).
- Put the interests of the corporation ahead of the individual interests of the board members.

The Reasonableness Standard requires the board to act reasonably. The main difference between the two standards is that courts generally do not second-guess good faith board decisions under the Business Judgment Rule, but courts determine what is reasonable under the Reasonableness Standard.

Most states and the Code follow the Business Judgment Rule, but some Georgia Courts have applied the stricter Reasonableness Standard. It's very valuable for communities to amend its bylaws to specify that the

Business Judgment Rule applies to all board actions. If the directors follow the Business Judgment Rule in discharging their duties, courts applying the rule will not second guess decisions of the board, even if the decision turns out to be a bad one.

IT'S A CONFLICT OF INTEREST . . .

Or is it?

Perhaps one of the most misused and misunderstood terms when it comes to understanding a director's duty to the association is conflict of interest. Association members and directors often are surprised to find that a legal conflict of interest does not always encompass every situation one may view as a conflict of interest. Likewise, many are surprised to learn that conflicts of interest are not illegal - a transaction can still take place, even if there is a conflict of interest, if proper procedures are followed.

Implied in the Duty of Loyalty is that a Board member will not make decisions on behalf of the association if the board member has a **conflict of interest**. According to the Georgia Code, a director has a conflict of interest if the director or a "related person" to the director:

- is a party to a transaction with the corporation;
- has a beneficial financial interest in the transaction with the corporation;
- is so closely linked to the transaction and it is of such financial significance to the director or a related person that it would reasonably be expected to exert an influence on the director's judgment and vote; and

- is also a director of or controls the company or any affiliated company with which the association is contracting.

Examples of a “**related person**” include the director’s spouse, parent, sibling, child or grandchild, or a person living with the director.

Essentially, if a director is connected to someone who might benefit from the transaction, the director has a conflict of interest and needs to resolve it. (If the director asks himself, “Do I have a conflict of interest?” he probably does!)

To resolve the conflict of interest, the director with the conflict of interest must disclose the conflict to the other board members, and after the disclosure, the transaction must be approved by:

- a majority (but not less than two) of the “qualified directors;”
- a committee empowered by the board to vote on the transaction; or
- a majority vote of the membership.

A “**qualified director**” is:

- Any director who does not have a conflict with the transaction.
- Any director who does not have a familial, financial, professional or employment relationship with the director who does have a conflict.

Can the conflicted director still participate in the board discussion about the transaction and vote on the transaction? The answers depend on what information, if any, the conflicted director can disclose to the board about the source of the conflict.

If the conflicted director cannot disclose the reason for the conflict, the conflicted director can remain in the room (unless the board chooses to have the director leave), but **CANNOT** participate in the discussions or vote on the transaction. An example of this is where the conflicted director is a bankruptcy attorney and one of the companies bidding on the association’s project is his client. Attorney-client privilege may prohibit him from disclosing this information. The conflicted director must



state that he has a conflict of interest that he cannot disclose and this statement should be reflected in the minutes of the meeting.

If the conflicted director can disclose the reason for the conflict, the director can be part of the board discussion and vote on the decision, unless the board chooses to require the director to not participate in the discussion and/or vote. However, the vote must pass by a majority of the qualified (non-conflicted) directors. The conflicted director’s vote cannot be the tie-breaker.

HELP, WE HAVE A ROGUE DIRECTOR!

Unfortunately, sometimes, directors do not see eye to eye. While differences of opinion can be valuable to boards, and most board debates or conflicts can be and often are resolved, this is not always the case. Occasionally, a board may run into a situation with a dissenting director who chooses to let his displeasure with a board be known to the board or the community in a



not so polite manner, or who refuses to recognize his obligation to not undermine the actions and decisions of the board. To address and resolve issues that a dissenting director might cause, many communities are adopting a **Codes of Ethics**.

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These Codes of Ethics can be adopted by amendment to the association's bylaws or by a resolution of the board. If adopted by resolution, each director or officer voluntarily should sign the Code of Ethics to be bound by it.

A Code of Ethics requires that directors comply with certain minimum standards of conduct. It commonly require directors to treat each other with courtesy and professionalism, to respect and support the decisions of a majority of the board, and to keep confidential any privileged information obtained as a director. Most importantly, if a director bound by the Code of Ethics breaches it, the Code can provide for remedies or sanctions against that director, which typically does not otherwise exist in most community bylaws. Establishing a Code of Ethics creates an internal code of conduct for directors and helps guide the community to meet the standards set by Georgia law.

The duties owed by officers and directors to an association are actually very simple, but they should not be taken lightly. In a community of 200 homes worth about \$250,000 each, the board is responsible for managing and protecting the value of a \$50 million asset! Knowing these duties helps boards discharge this significant responsibility and helps prospective directors feel comfortable with their role as a corporate director before jumping in.

If you have any questions about director duties, don't hesitate to contact us.



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