Community Trends

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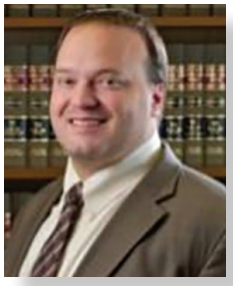

LEGISLATIVE UPDATE

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From time-to-time associations should review the legal protections that they are affording to their hard-working, volunteer boards. The first line of defense, of course, is making sure that the association is following procedural requirements. The business judgment rule protects the association and directors from having its decisions second-guessed or attacked in lawsuits. However, the business judgment rule only applies if the action taken by the board is within the scope of its authority and is not fraudulent, unconscionable, or self-dealing. If the board takes action without legal authority, the action is *ultra-vires* (i.e. without authority). There are two types of *ultra-vires* acts: (1) those that are *ultra-vires* in the "primary" sense (i.e. the board did not have the authority to take the action no matter what); and, (2) actions that are *ultra-vires* in the "secondary" sense (i.e. the board did not follow proper procedural requirements, such as approving the action in a meeting open to attendance by unit owners).

Therefore, boards should review their operating procedures to ensure that the actions they are taking are authorized in both the primary sense (i.e. is the action prohibited by law or the governing documents, or does it require owner approval) and the secondary sense (i.e. was it approved in a properly noticed public meeting).

In that connection, and as the second line of defense, a board should consider seeking legal advice regarding whether it has the legal authority to take a proposed action. This is because New Jersey corporate law contains statutes providing that directors do not have personal liability if, in taking an action, they reasonably relied upon the advice of counsel. Therefore, the value in obtaining a legal opinion is not only in "getting it right," it also provides an additional layer of protection for the board.

The third line of defense in avoiding claim exposure is making sure that the association has appropriate directors and officers ("D&O") insurance in place. This analysis should involve not only ensuring that there is a D&O policy in place, but also in ensuring that the policy provides sufficient defense coverage for the types of claims that a community association director may expect to face. For example, many "package" D&O policies (i.e. a D&O policy that is part of a commercial general liability policy) may exclude not only coverage, but also the defense of discrimination claims. Under that circumstance, if a claim is brought against an individual director, the director may be left defending the case out of pocket unless the association agrees to advance legal fees in advance of a judgment pursuant to an advancement undertaking. Therefore, it is important that boards seek the advice of their insurance professionals and legal counsel when binding a D&O policy.

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The fourth line of defense is afforded by indemnification and exculpation provisions set forth in the association's bylaws or articles of incorporation. The vast majority of association governing documents contain provisions in this regard, and those provisions should be periodically

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reviewed to determine whether they should be updated or enhanced from time to time through governing document amendments.

The final line of defense is statutory indemnification provisions set forth in New Jersey corporate law. Generally speaking, these laws permit, but do not require, the advancement of legal expenses while a suit is pending. They also generally mandate that the association pay or reimburse legal expenses if the director successfully defends a suit, and permit, but do not mandate, the reimbursement of legal expenses in the event of an unsuccessful defense under certain circumstances.

The last thing a volunteer director needs is to have to pay legal fees, which could run into the hundreds of thousands of dollars, out of his or her own pocket. Therefore, directors should be cognizant of these issues.

As an interesting note on the above issues, courts have often determined that directors who were successful in suing an association and vindicating their rights as directors (i.e. such as challenging an improper removal or improper exclusion from meetings) are entitled to reimbursement of legal fees under governing documents or statutory authority. A recent New Jersey Supreme Court case called *Boyle v. Ocean Club Condominium Association,* 2024 WL 2753874 determined that indemnification clauses must be narrowly construed against the party seeking indemnification, and that indemnification of a so-called "first-party claim" (as opposed to a "third-party claim," meaning a claim by someone not on the board) will only be found if such indemnification is "expressly" provided in the governing documents.

The indemnification language in the association's bylaws stated:

> The Trustees and officers shall not be liable to the Unit Owners for any mistake of judgment, negligence or otherwise, except for their own individual willful misconduct or bad faith. The Association shall indemnify every Trustee and officer ... against all loss, costs and expenses, including counsel fees, reasonably incurred by him in connection with any action, suit, or proceeding to which he may be a party by reason of his being or having been a Trustee or officer of the Association except as to matters as to which he shall be finally adjudged in such action, suit or proceeding to be liable for willful misconduct or bad faith. In the event of a settlement, indemnification shall be provided only in connection with such matters covered by the settlement as to which the Association is advised by counsel that the person to be indemnified had not been guilty of willful misconduct or bad faith in his performance of his duty as such Trustee or officer in relation to the matter involved.

The Supreme Court determined that while the second sentence could imply that a director or officer who successfully sues the association should be indemnified, when the entire clause is read it is clear that it was only intended to apply to "third-party" claims by Unit Owners. The Court stated:

In short, the interplay between the third sentence, in which the Association's own counsel must judge the indemnitee trustee's behavior, and the first sentence, which provides that trustees "shall not be liable to the [u]nit [o]wners," suggests that the more reasonable interpretation of the second sentence is that the agreement was meant to cover any and all actions by unit owners who bring actions against trustees in their capacity as trustees.

What is potentially concerning about the Court's narrow interpretation and its decision to focus on sentences other than the actual indemnification sentence is the implication that an indemnity provision such as that in the Ocean Club case may only extend to "third-party" claims by unit owners, and not "third-party" claims by others. Furthermore, the Court did not address what impact, if any, the indemnification statute may have on the court's analysis, nor is it clear what indemnification obligation may exist if, for example, a newly empowered board with a vendetta against former directors chose to use the corporate power to bring suit against those former directors.

Therefore, it may be prudent for directors to re-evaluate the indemnity language in their governing documents with legal counsel in light of the Ocean Club case. ■