No. 99138-3

SUPREME COURT
OF THE STATE OF WASHINGTON

MATT SUROWIECKI, SR.,

Petitioner,

and

LARRY BANGERTER; ALEX AND ELENA BORROMEO; CAMP FIRE SNOHOMISH COUNTY; CAROL BRITTEN; JAMES WAAK, individually and as lot owners and derivatively on behalf of HAT ISLAND COMMUNITY ASSOCIATION, a Washington non-profit corporation,

Plaintiffs,

v.

HAT ISLAND COMMUNITY ASSOCIATION, a Washington non-profit corporation; CHUCK MOTSON, an individual; KAREN CONNER, an individual; ALAN DASHEN, an individual; SUSAN DAHL, an individual; and JOHN DOES 1-10, individuals,

Respondents.

REPLY IN SUPPORT OF PETITION FOR REVIEW

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A. INTRODUCTION

The Hat Island Community Association ("HICA") has filed a cross-petition for review narrowly confined to the issue of whether the business judgment rule exonerates a homeowners association from liability for breach of the covenants pertinent to its authority or breach of its fiduciary duty.[1] Division I's opinion was thorough and thoughtful in its rejection of the business judgment rule as to HICA. Op. at 12-20. This Court should deny review as HICA has failed to document grounds for this Court granting review. RAP 13.4(b).[2]

B. REPLY ON STATEMENT OF THE CASE

The factual centerpiece of this case is that HICA breached the covenants pertinent to the Hat Island properties over which it had authority[3] by levying grossly inequitable assessments upon owners of undeveloped and undevelopable lots, tanking the value of such lots, and mismanaging various projects, including a $5.4 million marina expansion project, allowing costs to skyrocket without necessary prudent fiscal management

[1] HICA *nowhere* mentions in its answer Division I's decision vacating the trial court's fee award in its favor. Accordingly, it has waived that issue before this Court.

[2] The *only* grounds HICA invokes for review by this Court is RAP 13.4(b)(4). It seemingly *concedes* that Division I's opinion on the business judgment rule is not contrary to decisions of this Court or the Court of Appeals.

[3] Hat Island has been developed in multiple divisions. The CC&Rs conferring authority on HICA apply in only 12 of those 21 divisions.

and hiding costs from lot owners by refusing to provide legally-mandated audits or complete financial statements.

HICA posits a remarkably misleading picture of its board's decisions over the years, as well as a benign picture of how its assessment structure functions. Answer at 2-5. HICA's assertion that its uniform lot assessment and use fees are "equitable" is pure hokum. That false narrative is belied by the HOA's reality that lot owners with developed properties with views who use the golf course and marina are subsidized by the dirt lot owners whose properties lack water and can never be developed. Appellant's br. at 3-11. For purposes of review on summary judgment, this Court must treat the facts and inferences from those facts in a light most favorable to Surowiecki. *E.g.*, *Keck v. Collins*, 184 Wn.2d 358, 370, 357 P.3d 1080 (2015).

C. ARGUMENT IN REPLY

(1) Division I Correctly Ruled that the Business Judgment Rule Only Applies to Officers and Directors Individually; It Does Not Immunize a Corporate Entity for Violating its Contractual Obligations

The Court of Appeals correctly concluded that the business judgment rule is not applicable to claims against the corporation itself, only to the officers serving them. Op. at 19.[4]

[4] *See McCormick v. Dunn & Black, P.S.*, 140 Wn. App. 873, 887, 167 P.3d 610

The Court of Appeals correctly concluded that the trial court committed a fundamental error by applying the business judgment rule to dismiss Surowiecki's claims against HICA as a nonprofit corporate entity in addition to its corporate officers. *McCormick*, *Para-Med. Leasing*, and *Riss*, *supra*. HICA makes little effort to circumvent the Court of Appeals' ruling on this threshold issue. It merely cites a single, 45-year-old case that does not stand for the proposition that a corporation is immunized under the business judgment rule. Answer at 6 (citing *Nursing Home Building Corp., v. DeHart*, 13 Wn. App. 489, 498-99, 535 P.2d 137 (1975) (in a lawsuit against a company's shareholders as individuals, the Court said that the business judgment rule may "immunize[] *management* from liability in a corporate transaction.") (emphasis added).

But even notwithstanding that error, which Division I properly

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(2007), *review denied*, 163 Wn.2d 1042 (2008) (majority shareholders invoking business judgment in effort to shield themselves from personal liability following formation of partnership; business judgment rule only available to shield management); *Para-Med. Leasing, Inc. v. Hangen*, 48 Wn. App. 389, 396, 739 P.2d 717, 722, *review denied*, 109 Wn.2d 1003 (1987) ("In considering the actions of *a corporate officer*, however, the business judgment rule rather than the standard of ordinary care applies. This rule shields *the corporate officer* from liability so long as he acts in good faith without a corrupt motive.") (emphasis added); *Riss v. Angel*, 131 Wn.2d 612, 632, 934 P.2d 669 (1997) (rejecting members of homeowners' association attempt to invoke the business judgment rule to shield themselves from liability following rejection of plaintiff property owner's building plan; "It is clear that the [business judgment] rule, if applied here, would not exonerate the homeowners for their unreasonable decision to reject Plaintiffs' proposal."); Adam J. Richins, *Risky Business: Directors Making Business Judgments in Washington State*, 80 Wash. L. Rev. 977, 981 (2005) ("The business judgment rule operates to insulate directors from personal liability associated with business decisions.").

corrected, the rule has no application to this case. It is simply not applicable to nonprofit homeowners' boards or to contract disputes involving a homeowners' board's failure to abide by governing documents such as the covenants in this case which only permit assessments on an "equitable" basis and for the "mutual benefit" of its members. Thus, the trial court was wrong to defer to HICA's decision to levy equal assessments on every lot, whether developed, undeveloped, or undevelopable.

(2) Division I Correctly Ruled that the Business Judgment Rule Does Not Apply to Non-Profit HOA Boards

The business judgment rule addresses concerns which only apply in the corporate world where the pressures and pace of the free market both demand deference to corporate decisions and provide protections against corporate malfeasance, freeing individual board members from liability, but leaving the HOA itself liable for breaches of contract or fiduciary duty. *See McCormick*, 140 Wn. App. at 887; *Para-Med. Leasing*, 48 Wn. App. at 396.

HICA fails to cite a *single* case in which the rule has been applied to an HOA. That is because no court in this state has done so. To the contrary, this Court in *Riss*, 131 Wn.2d at 612, recognized that the "role of the business judgment rule where homeowners associations is concerned is the subject of ongoing debate." *Id.* at 631. The Court specifically declined to settle that debate, and instead determined that the board's actions in that

case would be actionable even "if [the business judgment rule] applied." *Id.* at 633.

Critically, the Legislature has set the appropriate standard for HOA board conduct, declining to adopt a business judgment rule. RCW 24.03.127 sets the standard to be applied to the conduct of nonprofit corporate directors. *See* Appendix. RCW 64.38.025 incorporates it by reference for HOA board members' conduct. In *Waltz v. Tanager Estates Homeowner's Ass'n*, 183 Wn. App. 85, 332 P.3d 1133 (2014), the court held that HOA members may sue an HOA board for negligence in performance of their duties, applying standard of RCW 24.03.127.[5]

Scholars have written that it makes little sense to apply the business judgment rule to HOAs that have a monopoly over their members, lack the controls of the free market, and do not face the same fast-paced business decisions as the corporate world.[6] An HOA's duties are in stark contrast to those of a corporate board. An HOA board does not exist solely to maximize stockholder wealth, nor are there stockholders in an HOA.

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[5] *Accord*, *Bellevue Farm Owners Ass'n v. Stevens*, 13 Wn. App. 2d 1052, 2020 WL 2318095 at *28, *review denied*, 575 P.3d 1039 (2020) (concurring in *Waltz* court view that RCW 24.03.127 governs the conduct of nonprofit corporation's directors).

[6] Denise Ping Lee, *The Business Judgment Rule: Should it Protect Nonprofit Directors?*, 103 Columbia L. Rev. 925, 958 (2003); *see also*, Bernard S. Sharfman, *The Importance of the Business Judgment Rule*, 14 *NYU Journal of Law & Business* 27 (Fall 2017) (arguing that a corporate board exists only to maximize stockholder wealth, and the business judgment rule "serves to support that purpose *and only that purpose*.") (cited in HICA's resp. br. at 26); *Riss*, 131 Wn.2d at 631.

Rather, an HOA board like HICA is tasked with balancing the interests of its many member/stakeholders, ensuring that covenants and bylaws are enforced, and preserving the common areas for the benefit of the individual property owners. Specifically, HICA was tasked by the CC&Rs with imposing assessments only in an *equitable* manner so as to benefit the whole Hat Island community while "preserv[ing] and protect[ing] the real and intangible values of the Island owner's personal and community properties." CP 1984, 1994, 2008. It did not do so. Its grossly inequitable assessments tanked the value of the dirt lots to the point that they are worthless and "under water." CP 2035, 2154, 2215. The business judgment rule does not immunize HICA's board from responsibility for violating the CC&Rs by levying *inequitable* assessments.

Not only does the business judgment rule have no application to HOAs in general, it is particularly unsuited to actions seeking to enforce the contractual promises contained in governing documents like the CC&Rs at issue here. *See, e.g.*, *Shinn v. Thrust IV, Inc.*, 56 Wn. App. 827, 836-37, 786 P.2d 285, *review denied*, 114 Wn.2d 1023 (1990) (holding that the business judgment rule has no application to a suit brought seeking to enforce "specific contractual duties" in a corporate entity's governing documents).

This Court applies contract law when evaluating such breach of covenant cases, applying principles of contract interpretation as opposed to

simply deferring to one party's preferred interpretation of a contractual duty. *Wilkinson v. Chiwawa Communities Ass'n*, 180 Wn.2d 241, 327 P.3d 614 (2014) (holding that in interpreting a covenant applying to a homeowners' association, the court "appl[ies] the rules of contract interpretation); *see also, generally*, 17 *Wash. Prac., Real Estate* § 3.2 (2d ed.) (enforcement of real property covenant is a "matter of the law of contract").[7]

Here, Surowiecki sought to enforce the covenants' contractual mandate that assessments only be imposed equitably. The business judgment rule has no application to such cases involving the interpretation of covenant language. This Court has long recognized the right of community association members to "attack assessments deemed to be unreasonable and the result of an abuse of discretion" under an association's governing documents. *Rodruck v. Sand Point Maint. Comm'n*, 48 Wn.2d 565, 576-77, 295 P.2d 714 (1956). Indeed, this Court's opinion in *Wilkinson* where the HOA board made decisions it thought were reasonable when implementing the CC&Rs would be subject to question if HOA boards could utilize the rule as HICA contends. *See also, Ackerman v.*

[7] Here, one can see that review is warranted with respect to the issues raised in Surowiecki's petition. This Court must correct the trial court's outlier decision that a court cannot review substantive duties in HOA covenants applying contract law but rather must confine its review to procedural fairness. That is not the law in this state.

Sudden Valley Community Ass'n, 89 Wn. App. 156, 944 P.2d 1045 (1997) (covenants provided that assessments must be equitable; no hint that business judgment rule foreclosed an action challenging a tiered assessment structure). This is the majority, if not universal, rule across the country.[8]

The CC&R's narrowly circumscribed HICA's discretion to levy assessments. They mandated that HICA may only impose assessments "on an equitable basis" and "for the mutual benefit of all HICA's members." CP 1984. HICA's founders *restrained* the board's assessment authority, imposing the equitable requirement to limit costs and preserve the Island as an option for persons of modest means. *See, e.g.*, CP 2064 (assessments were initially capped at five dollars). Surowiecki's lawsuit clearly sought to enforce the contractual terms of the CC&Rs, and any notions of "business judgment" or judicial deference to board decisions do not apply.[9]

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[8] Other jurisdictions agree and have refused to apply the business judgment rule to disputes over contractual language in HOA governing documents. *See Ewer v. Lake Arrowhead Ass'n, Inc.*, 817 N.W.2d 465, 477 (Wis. App. 2012) ("[T]he business judgment rule is not relevant to the proper construction of an HOA's bylaws, which are generally construed according to the principles of contract construction.") (specifically addressing dispute over assessments); *Davis v. Lakewood Prop. Owners Ass'n, Inc.*, 536 W.3d 743, 749 (Mo. App. 2017) (HOA board was not entitled to invoke business judgment rule where homeowners alleged that its calculation of assessments conflicted with the governing documents); *Ekstrom v. Marquesa at Monarch Beach Homeowners Ass'n*, 86 Cal. Rptr. 3d 145, 156 (Cal. App. 2008) (HOA board was not entitled to "judicial deference" in a dispute over its interpretation of the CC&Rs); *see also, Willmcshen v. Trinity Lakes Improvement Ass'n*, 840 N.E.2d 1275 (Ill. App. 2005); *Sheenstra v. California Dairies, Inc.*, 153 Cal. Rptr. 3d 21 (Cal. App. 2013) (cited in appellant's br. at 22-24). HICA is simply wrong to conclude that the business judgment rule applies to this contractual dispute.

[9] This case might be different, for example, if the CC&Rs granted HICA the authority to impose assessments "as necessary" or "as the board sees fit." But even then,

Moreover, the rule that an HOA board must follow the language of its governing documents is mandated by statute. RCW 64.38.020. Individual board members cannot invoke the business judgment rule to shirk their statutory obligations and liabilities. *Durand v. HIMC Corp.*, 151 Wn. App. 818, 836, 214 P.3d 189, *review denied*, 168 Wn.2d 1020 (2009) (business judgment rule does not protect corporate officers from illegal withholding of wages). The business judgment rule simply does not apply to breach of contract actions against HOAs.

Finally, the rule is particularly inapplicable to breach of fiduciary duty actions. HICA neglects to cite a *single case* in support of the view that a breach of fiduciary duty can be an appropriate "business judgment" because there is no such case for obvious reasons. Instead, HICA repeats the claim that Surowiecki never pleaded such a claim or, illogically, that he dismissed a claim he never had. Answer at 13-14. Surowiecki has already debunked this erroneous aspect of the Division I opinion that does merit review. Pet. at 15-17.[10] This Court should deny review of HICA's

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HICA's board owed a duty to its members to avoid having undeveloped lot owners subsidize owners of developed lots.

[10] Surowiecki argued below that *HICA* owed a fiduciary duty to its members. CP 186-87. The trial court conceded that HICA's board owed the members a duty of care. CP 207 ("It is true the HICA Board owes the membership a duty of care."). A corporation can only act through its board. The trial court conflated the actions of its board with HICA. Surowiecki properly raised the argument on HICA's breach of fiduciary duty, contrary to Division I's belief.

unsupported belief that the business judgment rule can foreclose a breach of fiduciary duty claim against an HOA.

D. CONCLUSION

This Court should grant review on the issues of the inequity of the assessments, and Division I's decision to confine the determination of whether the assessments were "equitable" to a procedural exercise, and the dismissal of Surowiecki's breach of fiduciary duty claim. It should deny review on the application of the business judgment rule to HOAs.

This Court should reverse the trial court's order on summary judgment. Costs on appeal should be awarded to Surowiecki.

DATED this 4th day of December, 2020.

Respectfully submitted,

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APPENDIX

RCW 24.03.127:

A director shall perform the duties of a director, including the duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation, and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

In performing the duties of a director, a director shall be entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, in each case prepared or presented by:

(1) One or more officers or employees of the corporation whom the director believes to be reliable and competent in the matter presented;

(2) Counsel, public accountants, or other persons as to matters which the director believes to be within such person's professional or expert competence; or

(3) A committee of the board upon which the director does not serve, duly designated in accordance with a provision in the articles of incorporation or bylaws, as to matters within its designated authority, which committee the director believes to merit confidence; so long as, in any such case, the director acts in good faith, after reasonable inquiry when the need therefor is indicated by the circumstances and without knowledge that would cause such reliance to be unwarranted.

DECLARATION OF SERVICE

On said day below I electronically served a true and accurate copy of ***Reply in Support of Petition for Review*** in Supreme Court Cause No. 99138-3 to the following:

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I declare under penalty of perjury under the laws of the State of Washington and the United States that the foregoing is true and correct.

DATED: December 4, 2020, at Seattle, Washington.

/s/ Frankie Wylde
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TALMADGE/FITZPATRICK

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