

Top Ten Most Common D&O Insurance Claims

Introduction

Community Associations, whether a Homeowners' Association, Property Owners' Association, Cooperative, Timeshare/Interval Association or Commercial Association are legal entities that are governed by by-laws and applicable statutory and governmental regulations. The Directors and Officers of the Community associations are the core infrastructure for the entities charged with the governance of the entity. These boards are virtually always comprised of volunteers who generally have the greatest intentions when serving. However, boards are confronted with some basic inherent challenges. First, boards often lack experience or training. Second, boards often succumb to a false sense of security by handling matters informally. Third, boards ignore the basic rules and governing documents. Finally, boards too often shy away from professional guidance.

Proposed Solution:

- identify the most common claims;
- identify why these common claims occur;
- learn how to avoid these claims in the first instance;
- if a claim still occurs, and it will, learn how to informally resolve claims before they explode; and,
- learn how to maximize the resolution of a claim with hints from the insurer.

We hope that this article and presentation will assist community associations in maximizing their ability to attract the best talent in the community to serve on boards and in turn help avoid the most common claims which indeed are very avoidable.

Before the claims are identified, it is helpful to put the world of community association directors' and officers' claims in context.

- First, claims against Directors and Officers of community associations are mostly comprised of defense fees, claim expenses and litigation costs, mostly paid by the insurance carriers.
- The common claims identified below rarely get to trial and rarely result in any type of monetary damage payment.
- As opposed to property or casualty damage claims, most claims against community association boards are easily avoidable.

What Are The Most Common Directors' & Officers' Claims?

The Most Common Non-Profit Community Association Directors' & Officers' Claims are as follows:

- The Board's failure to adhere to by-laws
- The Board's failure to properly notice elections
- The Board's failure to properly count votes/proxies
- Challenges by members regarding power granted the Board by by-laws
- Improper removal of Board Members
- Decisions by the Board resulting in physical damage to the association's property
- Challenges to assessments
- Approval of variances, generally by an architecture committee
- Breach of fiduciary duty
- Challenges to decisions of the Architectural Review Board
- Questions or challenges regarding easements
- The Board's failure to maintain common areas
- The Board's failure to properly disburse funds (i.e. insurance proceeds)
- Defamation by the Board of a member

What Are The Causes For The Most Common Claims?

1. **The devil is the details. If you ignore the devil, it is likely to come back to haunt the Association later. *Failure to Follow the By-Laws.***
2. **Out of Sight Out of Mind. *Failure to Update or Memorialize Amendments.***
3. **Penny Wise and Pound Foolish - *Failure to hire the Critical Professionals***

4. **Ignorance is Bliss. *Failure to know and Follow New Laws***

5. **We'll get to it later. *Failure to Document and Keep Records***

6. **It's the Principle of the Matter. *Failure to put Emotions and Personalities aside.***

Community Associations are formal legal entities that are filed with the appropriate governmental agency in its state of incorporation. By-Laws and Declarations of Covenants, Conditions and Restrictions govern these entities. By and far, the failure to know and follow these governing documents is the most common cause of problems. This failure is very understandable. Community Associations often are very small or are comprised of community members who are very close - for all intents and purposes like family. Accordingly, very often things are done informally with simple procedures. Very often this is fine because there is no problem, no complaint and things just go on. As long as there is no problem, no one is concerned.

However, the associations are too often lulled into a false sense of security. Once a problem does occur, association members have a short memory and every one of the formalities set forth in the governing documents will be thrown back in the face of the board. Not only will it be thrown back in the board's face, the board will probably loose. A court will give full faith and credit to the governing documents and challenges to those procedures will not be easily won, even if the association has been doing things that way for years.

An ancillary issue is the entrance into the community of a newcomer. Although the community may have acted in a certain way for years, the newcomer will look to the governing documents. Accordingly, the unwritten rules followed for years, which contradicts the by-laws, may be successfully defeated by the newcomer who chooses to challenge.

Not only do boards fail to know or follow the governing documents, but also they fail to formalize changes and amendments. Once the first obstacle of knowing and following the governing documents is overcome, if the governing documents themselves are not accurate or in compliance with current laws, the association has two layers of problems and errors. First, many associations were created and organized years ago. Virtually every state has had many changes to laws that govern community associations,

including laws that contradict the existing governing documents. Like an individual's own business documents or estate planning, the association needs to have a compliance check-up for its documents. Associations change, laws change and these need to be reflected in the governing documents. Contrary to many myths, this is not an expensive proposition and is worth its weight in gold (gold that can be used for unavoidable claims).

A second related issue is the association's failure to formally amend changes to the governing documents. The association could have done everything perfectly in making a change, however, if it is not properly memorialized, they have both wasted time and defeated the purpose and intent of the change.

Community Associations are budget driven entities that rely on collecting the costs of running the association from its members. In good economic times, it is challenging to raise money. In current times where the economy is quite strained, it is even more difficult to justify certain expenses. We have found, however, that it is money well spent to retain experienced general counsel with whom to consult for the Association's operations. Every community in the country has counsel who specialize in community associations and know how to service the associations in a lean and mean fashion. The money spent up front with general counsel is far less than what will happen at the other end.

Although insurance will assist the association, frequency and severity of claims can make the acquisition of insurance and reasonable insurance costs difficult for the association. General Counsel should be budgeted and looked at as the cost of doing business. Counsel can also be a primary contact with the insurer and the defense counsel retained by the insurer once any litigation arises.

Failure to hire competent and experienced property management companies or property managers for community associations of certain size and complexity is another common mistake. The property managers are professionals who know what the board and the association needs to do, can facilitate board functions and carry out board directives. This is a substantial investment to obviate many problems that turn into claims.

Related to the use of professionals is the association's failure to follow changes in the law and have them incorporated into the association governance and governing documents. It is not necessary to have professionals handle this due diligence just as we can do our own plumbing if we want and we can represent ourselves in court. The choice belongs to the associations, however, the association will not be able to raise a defense of ignorance of the law. If the association chooses to maintain self governance without property managers or counsel, which many, many associations do very successfully, the board itself will have a certain added degree of obligation and due diligence.

What happens in many associations is that there is one person who leads the association for years and years and then either passes on or moves away. The

association is then left without any continuity and if the by-laws have not been updated and changes memorialized, the association will end up spending far more in reaching compliance. The failure to obtain professional help at appropriate times in and of itself could constitute a breach of fiduciary duty by the board.

Association operations can be document critical. Unfortunately, the same informal attitude of governance carries over to the issue of keeping good records and proper records both with respect to financial issues, budget issues, maintenance issues and anything else that is required of the specific association. Good file keeping goes a long way toward successfully defending the Association's position.

For reasons that can be left to a good psychological/sociological doctoral thesis, Community Association Directors and Officers have a very difficult time distancing their duties and obligations from their personal emotions, egos and relationships. Maybe it is the notion that: "What's more important than one's home?" Very often, these board members run companies, businesses and other entities with professional demeanor and sense. However, when it comes to electing a board, painting a house a certain color, designating a parking space, allowing a member to have four dogs instead of two, emotions prevail and get in the way when trying to resolve issues prior to litigation.

From an insurer's point of view, this is a significant issue when it comes to underwriting an association that has had claims. If the association has developed a reputation for not being able to handle a matter without letting emotions and in-fighting get in the way, an insurer will think long and hard, because it will assume that any claim, no matter how small or large will go on and on and will be expensive.

What Can Be Done To Avoid The Common Claims?

In the area of directors' and officers' liability, as opposed to other types of casualty insurance, the most common types of claims are avoidable. For reasons again that can be the subject of a sociological study, people do not take seriously the governance of their community association. As employees, the association members go to great lengths to make sure they do their job by the book. On the other hand, when they are on a board that governs a community wherein they have invested their greatest asset, they do not take things as seriously.

What can be done to avoid the most common claims? A great deal can be done and the effort and resources are not significant in most cases:

Follow the rules.

1. Know the by-laws and any other governing documents.
2. Require all board members to read the by-laws.
3. Ensure that new association members receive and sign off on the by-laws and governing documents when they move into the community.

4. Know the rules governing elections and follow them. The current members may not have a problem, but what if a third party or a new association member challenges decisions of a board that was not properly elected?
5. Know the rules regarding assessments.
6. Know the rules regarding failure to comply with assessments.

Make sure the rules are current

1. Conduct a periodic review of the governing documents.
2. Retain counsel to make sure that the association is advised of new laws and developments.

Memorialize Changes

1. Make changes pursuant to the By-laws.
2. Make sure the changes are memorialized and the By-laws are properly amended.

Elect Board Members who are serious

1. Make sure potential board members know what the job entails.
2. Make sure the potential board member is willing to take the job seriously.
3. Provide training for board members as a governing board.

Use Professionals

1. Regardless of the size of the association, counsel should be retained for major transactions. Unless the association has a management company that is experienced with collecting assessments and liens, hire counsel to handle these transaction and procedures.
2. There is affordable counsel for community associations. All counsel will negotiate for an appropriate engagement relationship. It is cheaper to invest a known amount up front than having to submit a claim to an insurer or hire an attorney after something goes wrong.
3. Retain the services of a community Management Company or manager, even if it is only for certain activities such as running board meetings and managing the boards activities. Unless the association has a volunteer board member who is willing to handle the formalities, it is worthwhile to use a professional.

Do Not let Emotions and Personality Get in the Way

1. Avoid emotions and personality conflicts. These have led to some of the greatest wastes of time and resources in the area of directors' and officers' claims.
2. Follow basic rules for running meetings as a method of avoiding the opportunity of emotions and personality conflicts getting in the way.

Immediately forward Demand Letters or Lawsuits

1. The directors' & officers' policy is a claims made policy that generally requires that the association forward all claims as soon as reasonably possible (and very often within the policy period).
2. The directors' & officers' policy is a claims made policy that generally requires that the association forward notice of facts or circumstances that may give rise to a potential claim.
3. There is no down side to forwarding potential notices of facts or circumstances. Most insurers in this area will not penalize, and should not penalize, an insured for providing notice. The insurer is in the business of risk management and can assist in early resolution of claims or situations.

Alternative Dispute Resolution

1. Associations should consider early on the possibility of mediation to resolve any claim or litigation.
2. Communication is the key to resolution of problems. The association should consider having a mechanism in place for the community association to address conflicts and grievances.

What Can Be Done If The Claim Cannot Be Avoided To Maximize The Outcome In The Association's Favor?

Provide Notice As Soon As Reasonably Possible

- Importance of notifying all matters to all insurance carriers
 - any litigation
 - any letter requesting monetary or non-monetary relief
 - any EEOC, HUD or similar proceeding
- Importance of timeliness of notice (as soon as possible)

- Importance of providing all relevant documents associated with the matter

Cooperate with the Insurer in its Investigation

1. Assist the insurer when contact is made to investigate the facts.
2. Provide all relevant documents
3. Anticipate questions as to:
 - the identification of the claimant/plaintiff
 - the identification/status of the defendants to determine potential insureds
 - the chronological background of the incident/claim
 - any action taken by the insured

Cooperate with Appointed Counsel

1. Contrary to various misconceptions, the insurer appoints counsel that it believes will most effectively and expeditiously resolve a claim. The association may believe that its own general counsel should defend them, because that counsel knows them. However, very often that counsel may have a conflict (they may have been involved in the facts giving rise to the claim), they may not have the specific expertise as appointed counsel, and may not know how to effectively communicate with the insurer.
2. Provide the appointed counsel with any necessary information, facts and documents.

Be Prepared to Evaluate Settlement Proposals

- prior demand letters
- prior lawsuits
- employment contracts
- governing documents (By-Laws, CCRs, etc.