

“Business Judgment rule” applies to board decisions

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Directors are faced with difficult decisions during their term on condo boards. In exercising the board's decision-making power, the *Condominium Act* (the “Act”) requires directors to act honestly and in good faith, and exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstance. To do so, boards must balance competing interests, exercise its discretion and arrive at a decision. But what if unit owners don't agree with that decision? Who is to say the board is right?

In a recent Court of Appeal decision of **3716724 Canada Inc. v. Carleton Condominium Corporation No. 375**, the court affirmed that a “business judgment rule” applies to the condominium corporations and that a court will not interfere or second guess a condo board's decision so long as the board acted fairly and reasonably.

What the case is about

This case involves a mixed-use condominium building, containing both residential and commercial units located in a high-crime neighbourhood of Ottawa. One owner, 3716724 Canada Inc. (“371”) owned commercial parking units in the condominium and rented them out on a monthly basis. 371 wanted to rent the parking units on an hourly basis to increase its profits and asked the condominium corporation, CCC 375 to approve its proposed changes to the common elements under section 98 of the Act in order to facilitate its new operation. CCC 375's board was concerned that 371's proposed changes would make the building less safe since trespassers could easily enter the building. The board ultimately refused to approve the changes unless 371 hired a full-time security guard. 371 commenced an application for relief under the oppression remedy section of the Act (s. 135).

To determine whether CCC 375 conduct infringed section 135 of the Act, the application judge applied a two-part test (though not explicitly stated in the reported decision): a claimant must establish (1) a breach of their reasonable expectations, and (2) that the impugned conduct amounts to “oppression,” “unfair prejudice,” or “unfair disregard.”

The judge found that 371's plan to operate on an hourly basis was a reasonable expectation, but also accepted the board's security concerns as reasonable. The main issue became whether the board's decision disregarded 371's expectation unfairly. The judge found that having a full-time security guard was not a viable economical option for 371 and the board's insistence on that requirement unfairly disregarded 371's interests. The judge granted 371's oppression application and ordered that 371 was allowed to make its requested changes to the common elements without the need for a vote of the unit owners (despite the fact that the board chose to treat the change as “substantial” under section 97(6) of the Act).

CCC 375 appealed the application judge's decision and asked the Court of Appeal to answer the following question, among others: Did the application judge err in concluding that CCC 375 disregarded 371's interests?

The Court of Appeal unanimously confirmed that the “business judgment rule” applies to condominium corporations and a board's decision is owed deference by the courts. The Court expressly affirmed the application of the “business judgment rule” to condo corporations and reasoned:

This rule recognizes the autonomy and integrity of corporations, and the fact the directors and officers are in a far better position to make decisions affecting their corporation than a court reviewing a matter after the fact...the rationale underlying the business judgment rule in the corporate law context is also applicable to condominium corporations. As representatives elected by the unit owners, the directors of these corporations are better placed to make judgments about their interests and to balance the competing interests engaged than are the courts.



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Editor:
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The Court went on to set out the legal test for a court reviewing a board's decision:

[The court must determine] whether the directors acted honestly and in good faith and exercised the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. If they did, then the board's balancing of the interests of a complainant under s.135 of the Act against competing concerns should be accorded deference. The question in such circumstances is not whether a reviewing court would have reached the same decision as the board. Rather, it is whether the board reached a decision that was within a range of reasonable choices. If it did, then it cannot be said to have unfairly disregarded the interests of a complainant.

The Court further explained that the term "balancing" means that condo boards are balancing "competing interests of different natures...that cannot be reduced to a common unit of measurement." Condo boards must nonetheless attempt to strike a balance between differing and competing interests.

Ultimately, the Court found that CCC 375 reached a decision that was within a range of reasonable choices and that its board acted honestly and in good faith in considering 371's economic interests and balancing that interest against other unit owners' interest in keeping the building safe and secure. While the board's decision prevented 371 from increasing its profits, the Court concluded that the board's conduct did not amount to unfair disregard of 371's interests:

[The board] simply – in good faith and after a fair process – determined that legitimate and reasonable competing interest were more important...it was open to the Board to conclude that the increased security risk outweighed the respondents' commercial interests.

Why this case is important

Condominium boards can now breathe easier knowing that their decisions will not be scrutinized by the courts so long as their decisions were arrived at fairly and reasonably.

Because each condo is different, boards require flexibility in the decision-making process in order to properly weigh the many factors at play in any given situation, be it an owner's alteration request, the decision to enforce compliance against an offending occupant or contracting for building services. There is no way to satisfy the entire ownership and inevitably some owners will be unhappy with a board's decision, but boards don't have to keep everyone happy. This decision confirms that legitimate interests may compete when a board makes a decision, but a democratically elected board is best suited to balance the interests.

One of the ways a condo board can ensure it is acting reasonably is to consult professionals. Section 37(3) of the Act provides that a director shall not be found liable for a breach of duty if the breach arises as a result of the director's relying in good faith upon professionals such as an accountant, engineer or lawyer. Condo boards should consider involving its professionals in the earlier stages of its decision-making process to avoid problems with a potentially controversial decision.

Approach Kitec plumbing replacement strategically

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Between 1995 and 2007, almost 300,000 North American condominiums and houses were built with Kitec plumbing. This troublesome plastic plumbing was discontinued in 2005 when its pipes and fittings were found to corrode and fail prematurely, resulting in leaks and floods. A cross-border class action lawsuit ended in 2011 with a US\$125 million settlement, but condo boards have been left wondering how to deal with Kitec plumbing in their buildings.

The following are some suggestions for developing a comprehensive Kitec plumbing management strategy at condominiums:

1. Determine the prevalence and condition of Kitec plumbing

An essential first step in addressing a Kitec plumbing issue is to gather extensive information as to the location and prevalence of Kitec plumbing in the entire condominium. One good option is to obtain such information directly from the developer or otherwise from its documentation. A second option is to physically examine a selective sampling of Kitec plumbing. Both options are preferable to large-scale destructive testing.

It is also important to engage engineers early to devise and conduct the initial inventory of Kitec plumbing and document the condition thereof. Professional inspection will provide the necessary information to assess the situation and plan the next steps. The mere discovery of Kitec plumbing does not necessarily warrant complete remediation. Condo boards should slow down, be methodical and act only on complete information.

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2. Determine the legal obligations for maintenance and repair

Once the locations and extent of the Kitec plumbing are known, the board should consult the Corporation's lawyers to verify the legal obligation to maintain, repair and replace those components as per the Condo Act and the Corporation's declaration. Boards should remember that condominium declarations vary widely, so the obligations of one condominium may be different than others.

If the Corporation's declaration makes it an owner responsibility to maintain, repair and replace in-suite plumbing, understand that it is not easy or painless for owners to undertake such major work without considerable inconvenience and cost. It is possible to legally compel owners to undertake necessary maintenance and repairs, but this needs to be done delicately and with great sensitivity in order to avoid a major backlash. Worst case, the Condo Act empowers the Corporation to make damage repairs on behalf of an uncooperative owner and charge back the cost as a common expense.

3. Determine the disclosure obligations

Condominiums that are built with Kitec plumbing throughout the common elements or for which the Corporation is responsible to maintain and repair all in-suite plumbing may reasonably expect to incur costs to replace Kitec plumbing that fails or might fail. In these cases, the Corporation likely should disclose in its status certificates that there exists a circumstance that may give rise to an increase in common expenses. Such disclosure should be made until the board can determine the scope of the problem. The board should also plan a solution and budget the estimated cost in its operating budget or its funding plan for the reserve fund.

Many condominiums contain Kitec plumbing only in the units, where maintenance, repair and replacement of plumbing components is a unit owner responsibility. In these cases, where the Corporation faces no reasonable prospect of additional costs, no disclosure in status certificates may be required. Despite this, too many managers and boards feel compelled to disclose the presence of Kitec plumbing when it is neither legally required nor helpful to unit owners trying to sell their units. The board should check with the Corporation's lawyers before needlessly revising status certificates.

4. Check and monitor the status of Kitec plumbing

Kitec plumbing reportedly fails most often when it reaches 10-15 years old, but the odds of actual failure depend on other factors such as water pressure and temperature. While most Kitec installations are said to fail eventually, it is possible that Kitec plumbing may function without premature failure for many years. The key is to monitor the condition of the Kitec plumbing and watch for changes.

Each plumbing failure should be investigated and recorded so that trends can be identified early and the situation can be managed. It is critically important to keep track of how and when leaks occur, their location and the particular circumstances in order to determine whether, when and how to require large-scale replacement.

If leaks are few and far between, a large scale replacement project may not be necessary in the near-term, while a large number of failures in a short time may signal the need for quick and drastic action.

Enlisting the help of the owners and residents is vitally important in watching and reporting changes and problems. The board should remind owners and residents to be watchful and to report suspicious circumstances and should teach them how to avoid and mitigate leaks and floods. A proactive board should also hold town hall meetings and circulate helpful info via newsletters as the investigation progresses.

5. Talk to the owners early

Communicating clearly and early to unit owners and residents is vital in any Kitec plumbing investigation and subsequent management policy.

Indeed, owners arguably have a right to know the risks that their plumbing may fail and that they may need to replace their plumbing at their cost in the near-term.

Once the board has determined the extent of the Kitec plumbing and its condition and has received professional advice as to whether immediate action is required, the board must obtain a range of options and the various cost for those next steps.

However, before making a final decision as to the next steps, the board should hold an owners' meeting to report the findings, the options and their cost. Many boards make the critical mistake of making major decisions based on incomplete or erroneous information and, worst of all, before discussing the situation and options with unit owners. This lack of communication invariably leads to discord and conflict. Even if the board subsequently selects an option that some owners do not approve, it is easier to implement any option after having given owners a chance to hear the facts, ask questions and voice their opinions and suggestions.

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Look for the following GMA speaker **November 12, 2016:**
Andrea Lusk – SESSION 4A: 11:00 am – 11:45 am

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At all stages of any Kitec plumbing investigation and remediation plan, remind owners and residents to:

- Carry appropriate unit owners' insurance to protect themselves;
- Check regularly for visible signs of pipe failure and leaks;
- Report unusual conditions or emergencies to management promptly;
- Set up a savings fund to finance future replacement of in-suite piping;
- Ask management before undertaking in-suite plumbing work;
- Replace Kitec plumbing if undertaking any major renovation work;
- Use only licensed plumbers and, perhaps, the Corporation's contractors;
- Locate and learn how to use in-suite shutoff valves;
- Ensure suite door locks are keyed to building master;
- File a claim against the Kitec class action settlement; and
- Watch for updates from management.



6. Be insurance-minded

Kitec plumbing's impact on the Corporation's insurance claims history and premiums is a major factor in any condo board's decision as to whether, when and how to undertake large-scale replacement. If frequent floods are increasing premiums and deductibles, the board may wish to proceed quickly with a replacement project. On the other hand, if flooding is rare and is well-contained, the board may have flexibility as to the timing and scope of work, providing time for the Corporation and owners to budget for the work to be done later.

Regardless of when the work must be completed, timely disclosure of Kitec plumbing's existence may be a necessary part of a condominium corporation's duty of good faith to its insurer. Failure to disclose such circumstances once known may result in denied claims.

The board should speak with its insurance broker about whether the Corporation's insurer has any suggestions or preferences as to how Kitec plumbing is handled. Some insurers may have little or no risk tolerance for Kitec plumbing and may insist on speedy replacement, while others may be more willing to let the Corporation manage the problem with a more gradual approach, so long as the community is vigilant in mitigating against leaks.

7. Closely regulate and manage the owners' in-suite plumbing work

Corporations may enact bylaws or rules to implement a comprehensive policy for identifying, inspecting and replacing Kitec plumbing in the units. Such bylaws or rules may require owners to conduct periodic checks and replacement of Kitec components when repairs or renovations are being performed on related components or once that plumbing fails, and to report changes to management.

These bylaws or rules might also set out a process for owners to request permission to make plumbing changes and mandate adequate inspection of work and monitoring for problems before owners close walls, install tiles or lay floors. Many water escapes (including non-Kitec plumbing leaks) are caused by undocumented or improper plumbing work done by owners, so investing the time and resources in devising and implementing a strong inspection and enforcement program is a good investment to avoid flooding scenarios and insurance claims.

For maximum effect, a Kitec plumbing management program should create a registry for managers to input owners' requests and reports and track which units have had their Kitec plumbing removed. A meticulous program such as this will allow remaining units with Kitec plumbing to be identified quickly for urgent remediation if and when their Kitec fixtures fail.

8. Proceed cautiously

Boards should resist the urge to act impulsively when faced with Kitec plumbing. Instead, boards should obtain good advice from the Corporation's engineers, contractors and lawyers, gather information and options and then get the support of residents and owners.

It is important to focus on devising a plan that works for the community, rather than one that merely eradicates Kitec plumbing quickly at all costs and risks creating unrest among the owners.