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# Covenant Enforcement: The Role Of The Business Judgment Rule

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### **Covenant Enforcement: The Role Of The Business Judgment Rule**

The Colorado Court of Appeals has ruled homeowners associations are entitled to broad discretion in the manner and method of pursuing covenant enforcement. A lawsuit challenging those decisions must prove the association acted unreasonably, in bad faith or in an arbitrary and capricious manner.

Case law in Colorado provides that clear and unambiguous covenants must be enforced as written. Nevertheless, the courts have not previously provided guidance about how covenants should be enforced. Previous court decisions state that associations are entitled to exercise discretion in the decision-making process. The courts have given considerable latitude and deference to such decisions, meaning such decisions cannot be undercut or challenged simply by filing a lawsuit. This doctrine is known as the business judgment rule.

Prior court decisions had confirmed a homeowner association board is entitled to latitude in decisions concerning the areas of maintenance and repair, construction of common improvements and architectural control. A lawsuit challenging those decisions must prove the association acted unreasonably, in bad faith or in an arbitrary and capricious manner. Nevertheless, until the recent Cross Creek decision, the Colorado appellate courts had not focused on the deference and discretion allowed to homeowner associations in connection with covenant enforcement decisions. The tension between the obligation of covenant enforcement and the latitude afforded a board's decision in these areas had created uncertainty in the law.

#### The Background

In Colorado Homes, Ltd. v. Cross Creek Homeowners Association ("Cross Creek"), the Court of Appeals examined a board's obligations in the covenant enforcement process. Two lot owners had become embroiled in a bitter and prolonged dispute. One lot owner, Colorado Homes, was a home developer who owned approximately two dozen lots within the covenant controlled community. The other lot owner, Wilson, had purchased a home from the developer and had a warranty dispute. Wilson also claimed the developer had defrauded him with respect to the development of adjoining properties. The developer and purchaser had filed police complaints and temporary restraining order actions against one another. Wilson had posted a sign in his home window stating that the developer did not do warranty work. He also picketed extensively on public streets and sidewalks in front of the developer's sales trailer, which was located within the covenant controlled community.

The developer asked the association to enforce the covenants prohibiting signs and noxious or offensive behavior within the community. The Board investigated and found that Wilson had received statements from city officials that his activity was lawful, and had received two Court rulings finding that his picketing on public streets and right of ways was protected by the First Amendment. The Association was very concerned about the volatile nature of the parties and of the potential for violence. The Association did not file a covenant enforcement action, but sent a demand letter asking the owner to remove the sign posted in his home. The Association took no enforcement action concerning the picketing due to First Amendment considerations.

## The Court's Ruling

The developer ultimately sued both Wilson and the Association. The developer claimed the Association failed to properly enforce the covenants. On appeal, the Court of Appeals held "covenant enforcement may require the exercise of discretion as to both the timing and manner of enforcement." This means that for any claim brought against a homeowners association respecting covenant enforcement, the court or jury must determine whether the association has properly investigated, acted in good faith, and whether the association has acted arbitrarily or capriciously. "Good faith" means taking actions with honest intentions and without taking improper advantage of the circumstances. If there has been proper investigation, good faith and a lack of arbitrary or capricious conduct, a lawsuit challenging the association's discretionary decisions concerning the timing and manner of covenant enforcement and alleging breach of the covenants or breach of fiduciary duty will fail.

## Applying the Decision to Your Association

The court will consider the fiduciary duty owed by a homeowners association to the community as a whole, and the fact that a homeowners association has a fiduciary duty to enforce the covenants. Fiduciary duties impose a high legal standard upon homeowner associations and board members. This obligation is tempered by the business judgment rule allowing considerable latitude and discretion to the board's decisions as long as they are undertaken prudently and in good faith.

The Cross Creek decision provides a lesson that homeowners associations must carefully investigate and evaluate requests for covenant enforcement. The board must act prudently, in good faith, and with consideration of both the specific covenant violation and the overall interests of the community when making decisions about the strategies, timing and methods for enforcing the covenants.