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Duties and Breach of the Fiduciary Relationship, Including Confidentiality

Stephen Lasser · Friday, February 10th, 2023

As you might have read in our previous Business Judgment Rule article, in business there is a special relationship between parties that is created when one party, a fiduciary, has a duty to act for or give advice, usually for financially related matters, to the benefit and reliance of another party, a beneficiary. This fiduciary relationship exists in some form in almost every type of business from corporations and non-profits to real estate and trusts. Common examples of this widely prevalent business relationship are a director running a corporation on behalf of its shareholders or a condominium board responsible for managing a property for its homeowners. Given the pervasiveness and importance of this relationship in the successful governance of almost all types of businesses and financial matters, courts have established a precedent of the standards which a fiduciary must conduct himself or herself as follows: that any actions or duties taken by a fiduciary must be done in (1) good faith with the care of a reasonably prudent person, and (2) be in the beneficiary's best interest. This description of a fiduciary duty is often characterized as two distinct duties, (1) a duty of care and (2) a duty of loyalty.

The reasonably prudent person standard for the duty of care generally means that, where there is a fiduciary relationship, there is a responsibility to avoid any behaviors or omissions that a reasonably prudent person in a like position could reasonably foresee to cause harm to others. For example, in the context of a cooperative and condominium association, a board member is a fiduciary for the association members and therefore must make informed decisions on their behalf, such as knowledgably enforcing the association's governing documents, conducting informed inquiries before investing community funds into a major repair project, and budgeting for the current and future needs of the association. Failure to act in a reasonably prudent fashion, such as by failing to retain an auditor to review financial statements for potential future association needs, could potentially make the fiduciary personally liable for the beneficiary's economic losses. However, Courts will also concurrently consider the common law Business Judgment Rule and the Business Corporation Law (the "BCL") when deliberating on a breach of duty of care.

The Business Judgment Rule and the BCL may absolve a fiduciary of any harm they caused related to his or her duty of care as long as his or her decisions were rational and reasonable in the context of a business decision, meaning that the decision was not arbitrary, capricious or in made in bad faith. The rationale behind this magnanimous defense is that business decisions often have an element of risk and fiduciaries are not infallible, and no one would undertake such a position without some protection for honest mistakes. Most importantly the Courts recognize that such business decisions may require an expertise that the fiduciary may not have and therefore board

members are permitted to rely on the advice of professionals such as accountants and attorneys, even if such advisors end up providing poor advice.

However, the Business Judgment Rule and the BCL do not provide absolute defenses for a breach of fiduciary duty as Courts have recognized that issues such as fraud, illegality, gross negligence, or a conflict of interest cannot be excused by the existence of a reasonable and rational business purpose for a fiduciary's actions. Consequently, when faced with such situations, the Courts often analyze the second less forgiving prong of a fiduciary's duties, the duty of loyalty. As its name describes, a duty of loyalty requires a fiduciary to act in the interest of the beneficiary, and not for their own personal gain, whether financially or otherwise, meaning that they must not engage in self-dealing or usurp a corporate opportunity for their own benefit instead of the beneficiary's. For example, where a board is reviewing bids for a construction project, if a board member owns a contracting company and bids on the project, he or she must first reveal his or her interest before the board's deliberations and also abstain from the board's decision-making process or the board member's self-interest in profiting may be put ahead of the association's interest creating a conflict of interest and therefore a breach in his or her duty of loyalty to the association. Courts have generally found that when a fiduciary puts their own needs ahead of their beneficiaries' needs they are automatically in breach of the general purpose of a fiduciary relationship. Consequently, Courts will generally only provide leniency to a breach of the duty of loyalty if a fiduciary's actions meet strict tests of intrinsic fairness to the beneficiary and if the self-dealing or taking of the beneficiary's interests was fully and comprehensively disclosed and approved by the beneficiary in some capacity.

An important subset of the duty of loyalty also exists called a duty of confidentiality. The duty of confidentiality requires fiduciaries to keep information and materials such as board room discussions, sensitive financial documents, and contracts confidential. For example, board discussions and materials involving budgeting, the board's response to a resident's objectionable conduct, or hiring a new management company or legal counsel for the association need to be kept confidential during the board's decision-making process to retain trust and collegiality between board members and to prevent third-party action from interfering with the board's choices. Given the importance, of maintaining confidentiality among fiduciary board members, it may be advisable to require board members to sign a code of ethics that codifies rules of confidentiality and provides for removal of a board member upon his or her breach of the code of ethics and duty of confidentiality.

In conclusion, fiduciaries need to understand their duty of care and duty of loyalty to shield themselves from liability for their corporate actions, and should rely on professional advisors when making important or potentially controversial business decisions.

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