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## Judicial Deference and Institutional Character: Homeowners Associations and the Puzzle of Private Governance

Michael C. Pollack  
michael.c.pollack@gmail.com

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JUDICIAL DEFERENCE AND INSTITUTIONAL CHARACTER:  
HOMEOWNERS ASSOCIATIONS AND THE PUZZLE OF PRIVATE  
GOVERNANCE

Michael C. Pollack\*

*Much of the study of judicial review of governing institutions focuses on the institutions of public government at the federal, state, and local levels. But the courts' relationship with private government is in critical need of similar examination, and of a coherent framework within which to conduct it. This Article uses the lens of homeowners associations—a particularly ubiquitous form of private government—to construct and employ such a framework. Specifically, this Article proceeds from the premise that judicial deference is less appropriate the more unaccountable a governing institution is, and therefore develops a set of tests for institutional accountability. Applied to the homeowners association, this accountability analysis reveals that the analogy most often resorted to by state courts—that of the corporation—is inappropriate, because homeowners associations and corporations have fundamentally different internal accountability mechanisms. They therefore require different sorts of judicial review. The Article closes by employing the same accountability tests to show that a more fitting deference regime for homeowners associations could be drawn from an analogy to administrative agencies.*

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\* Trial Attorney, United States Department of Justice, Civil Division, Federal Programs Branch. J.D. 2011, New York University School of Law; B.A. 2008, Swarthmore College. I would like to thank Jennifer Arlen, Barry Friedman, Rick Hills, Samuel Issacharoff, Melanie Leslie, and Daryl Levinson for their guidance, critiques, and thoughtful suggestions. I would also like to thank the members of the Furman Academic Scholars Program for their insights, friendship, and boundless encouragement. Finally, Alan Pollack and Corlett Wolfe Wood both deserve more gratitude than I can express for their love and unflinching support. The views expressed in this Article are mine alone and do not represent those of the United States or the Department of Justice.

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## I. INTRODUCTION

Often, when we think of government, we tend to think of the elected institutions and figures of public government like Congress and the President, a state legislature and a governor, a city council and a mayor. Appointed institutions like federal and state administrative agencies may cross our minds next. And for all of these public institutions, we routinely rely on courts to provide a necessary check on the exercise of legislative and executive power, enforcing limitations of both constitutional and statutory dimensions. Because courts thus have the potential to shape the very nature of governance, the literature on the role of courts in reviewing governmental action is rightly voluminous.

But private government abounds too. Just as we ask public institutions to write and enforce laws and regulations, we ask private boards, some elected and some appointed, to make decisions and to exercise an enormous amount of influence over our investments, our property, and our everyday lives. Like public government, these private institutions are also governed by limitations of both “constitutional” and “statutory” dimensions. And as with public government, the governmental unit and the governed individuals both turn to courts to enforce those limitations. The question of the proper scope of judicial oversight and of the appropriate degree of judicial deference is thus just as important with respect to private government as it is to public government. But the existing scholarship does not devote nearly as much attention to the question from the perspective of private governance, at least not outside a specific context, such as the law of corporations. An analysis that looks across disciplines and across the public–private divide, however, can both bring to the surface and call into question the assumptions underlying a prevailing brand of deference or conception of the judicial role in a given context. In revealing new linkages, such an analysis can suggest more context-appropriate judicial roles and brands of deference.

One particularly salient framework in which to take up this kind of

analysis is that of the homeowners association (HOA), thanks both to its ubiquity and to the relative disengagement by courts and by those who study deference from the question of the deference HOAs receive. While scholars of land use and property law have raised the issue within the field, it is in sore need of attention from a broader, institution-based perspective—the kind of separation-of-powers and allocation-of-competencies inquiry that characterizes the public law side of this deference conversation. This Article seeks to contribute to that effort, both to add to the existing scholarship surrounding homeowners associations and, more broadly, to suggest a more comprehensive way of considering judicial deference across the public–private divide.

The virtual isolation of the study of homeowners associations to one area of scholarship is surprising given the pervasiveness of the institution. According to the Community Associations Institute, a community management organization, homeowners associations govern some 24.4 million housing units and 60.1 million people.<sup>1</sup> That means that nearly 20% of Americans live in some version of a HOA or a condominium, cooperative, or other planned community. In other words, for nearly 20% of the population, the set of regulations that most immediately governs their daily lives, homes, properties, and even pets do not stem from any local, state, or federal government, but are instead generated, administered, interpreted, and executed by a HOA. In states like Florida, California,<sup>2</sup> Texas,<sup>3</sup> New Jersey,<sup>4</sup> and Arizona, the HOA is a dominant residential arrangement, often outpacing ordinary publicly governed municipalities. And this is a relatively new and growing phenomenon: since 1960, the number of HOAs in the United States has increased by a factor of close to 500.<sup>5</sup> This growth may reflect the fact

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1. Industry Data, COMMUNITY ASS'NS INST., <http://www.caionline.org/info/research/Pages/default.aspx> (last visited Feb. 8, 2013); see also Tamara Lush, *Homeowner Associations Foreclose on Residents*, USA TODAY (July 9, 2011), [http://www.usatoday.com/money/economy/housing/2011-07-09-homeowner-foreclosure\\_n.htm](http://www.usatoday.com/money/economy/housing/2011-07-09-homeowner-foreclosure_n.htm) (“Today, one in five U.S. homeowners is subject to the will of the homeowners’ association, whose boards oversee 24.4 million homes.”).

2. EVAN MCKENZIE, *PRIVATOPIA: HOMEOWNER ASSOCIATIONS AND THE RISE OF RESIDENTIAL PRIVATE GOVERNMENT* 153 (1994) (noting that Florida and California have, respectively, the highest and second-highest number of HOAs in the country).

3. Wade Goodwyn, *Not So Neighborly Associations Foreclosing on Homes*, NAT’L PUB. RADIO (June 29, 2010), <http://www.npr.org/templates/story/story.php?storyId=128078864> (noting that, in Texas, there are 30,000 HOAs as compared to just 1,100 municipalities).

4. *Mulligan v. Panther Valley Property Owners Ass’n*, 766 A.2d 1186, 1191 (N.J. Super Ct. App. Div. 2001) (“New Jersey is among the states in which residential community associations are most common.”) (citing David J. Kennedy, *Residential Associations as State Actors: Regulating the Impact of Gated Communities on Nonmembers*, 105 YALE L.J. 761, 793 n.24 (1995)).

5. Lee Anne Fennell, *Contracting Communities*, 2004 U. ILL. L. REV. 829, 835 (2004) (observing that, in 1960, there were fewer than 500 HOA communities in the United States and that, as of 2003, there were close to 250,000 such communities); see also MCKENZIE, *supra* note 2, at 11 (similarly charting meteoric rise of HOAs).

that people view HOAs as providing superior governance services than the public government.<sup>6</sup> On the other hand, for many people looking to buy a home in those HOA-heavy states, the relatively scant supply of non-HOA housing, especially *new* housing, means that the market all but requires that they live in a HOA.<sup>7</sup> In fact, over 80% of newly constructed homes in the United States are in HOA communities,<sup>8</sup> and in one study in California, researchers found that 84% of the people living in a HOA had not been looking to buy into one.<sup>9</sup>

Whatever the reason, the HOA is a strikingly common governance and property relationship. It is also a significantly powerful one. Under the covenants and declarations, as the “constitutions” of HOAs are known, a governing board may have the authority to use its discretion to limit the color and exterior décor of homes and of structural additions;<sup>10</sup> the nuances of pet ownership;<sup>11</sup> the displays of flags, window decorations, and lawn ornaments;<sup>12</sup> and even, at least one board claims,

6. See Robert C. Ellickson, *Cities and Homeowners Associations*, 130 U. PA. L. REV. 1519, 1548 (1982) (arguing that HOAs are more efficient suppliers of public goods than regular municipalities and so attract residents in Tiebout sorting fashion); MCKENZIE, *supra* note 2, at 137 (observing that many HOAs advertise themselves as performing governmental functions better than ordinary municipalities).

7. See David L. Callies et al., *Ramapo Looking Forward: Gated Communities, Covenants, and Concerns*, 35 URB. LAW. 177, 178 (2003) (“In many parts of the country, it is increasingly difficult for prospective homeowners to find housing outside such communities.”); MCKENZIE, *supra* note 2, at 12 (noting that, in some areas, almost all new development is in HOAs and that “growing numbers of Americans who wish to purchase new houses are going to be living in [HOAs], and under the rule of private governments, regardless of their preferences”).

8. Lush, *supra* note 1.

9. Carol J. Silverman & Stephen E. Barton, *Shared Premises: Community and Conflict in the Common Interest Development*, in COMMON INTEREST COMMUNITIES: PRIVATE GOVERNMENT AND THE PUBLIC INTEREST 129, 137 (Stephen E. Barton & Carol J. Silverman eds., 1994); see also Paula A. Franzese, *Common Interest Communities: Standards of Review and Review of Standards*, 3 WASH. U. J.L. & POL’Y 663, 671 n.29 (2000) (discussing scholars who “maintain that common interest communities are intrinsically coercive in nature, with many residents deprived of a meaningful choice in the matter because of the dearth of desirable housing alternatives in tight markets” and collecting sources).

10. See, e.g., Mia Taylor, *Homeowners Association Showdown: Paint Colors Prompt Lawsuit*, ATLANTA J.-CONST., June 26, 2003, at JF 1 (discussing HOA lawsuit filed against residents for painting home brown and white and threats of legal action for single half-inch nail popped out of place, prompting many residents to testify to being “harassed by an overly controlling homeowners association” that has “to realize they can’t control our lives”); Marie McCullough, *It’s a Swing Set! There Goes the Neighborhood*, PHILA. INQUIRER, Oct. 9, 1991, at A1, available at [http://articles.philly.com/1991-10-09/news/25814221\\_1\\_swing-homeowners-association-chartwell](http://articles.philly.com/1991-10-09/news/25814221_1_swing-homeowners-association-chartwell) (discussing HOA demand to remove metal, as opposed to wooden, swing set).

11. See, e.g., John Singh, *Fat Dog Isn’t Welcome in the Land of Fat Cats*, ORLANDO SENTINEL TRIB., Mar. 13, 1992, at B4 (discussing HOA efforts to remove allegedly overweight dog from community); *Weldy v. Northbrook Condo. Ass’n*, 904 A.2d 188 (Conn. 2006) (discussing rule of maximum leash length).

12. See, e.g., MCKENZIE, *supra* note 2, at 15 (discussing story of Vietnam War veteran who was told by HOA that he could not fly American flag on Flag Day).

chaste outdoor kisses and other unidentified “bad things” engaged in by its consenting adult residents.<sup>13</sup> Juxtaposed against the political obsession with the size of the federal government, the relative silence regarding the truly immediate and pervasive nature of HOA governance may prompt one to wonder why there is not nearly the same level of concern about a person’s “right” to do with his or her home as he or she wishes: to display her personal tastes and to embrace his loved ones.

In addition to these perhaps silly aesthetic regulations, HOAs often have more substantial powers. For example, they can and do limit alienation and leasing rights. They can also foreclose on a resident’s house for nonpayment of association dues, even when that resident owns full equity in that house. In 2009, for example, a soldier deployed in Iraq received word from his wife that their HOA had exercised its power to foreclose on their house because she had missed two monthly dues payments. The HOA sold the Clauers’ \$300,000 home to a developer for just \$3,500—enough to satisfy the outstanding dues of a few hundred dollars plus added legal and filing costs—who turned around and sold it for a nearly 4000% profit.<sup>14</sup> Since then, Congress has passed the Servicemembers Civil Relief Act, a law that is designed to immunize deployed servicemembers from these sorts of foreclosures,<sup>15</sup> and the Clauers have apparently settled with the HOA and gotten their home back.<sup>16</sup> But the potential for this sort of HOA action remains; in thirty-three states, HOAs can foreclose in situations like this even without a court order.<sup>17</sup> In fact, HOA dues-related foreclosure filings make up over ten percent of all home foreclosures in the state of Texas, and efforts to reform HOA foreclosure powers there have failed.<sup>18</sup>

What the plights of the Clauers, the other HOA residents who find their homes sold out from under them, and the garden gnome enthusiasts and driveway kissers alike all illustrate is that, for millions of Americans, some of the most salient legal and political conflicts in their lives will pit them against their HOA and, in the words of some

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13. David Willman, *Woman Faces Fine for Kissing Her Date*, L.A. TIMES (June 16, 1991), [http://articles.latimes.com/1991-06-16/news/mn-1528\\_1\\_bad-things](http://articles.latimes.com/1991-06-16/news/mn-1528_1_bad-things) (discussing story of 51-year-old woman who, after giving her friend good-night kiss, received notice from HOA detailing, “RESIDENT SEEN PARKING IN CIRCULAR DRIVEWAY KISSING AND DOING BAD THINGS . . .”); see also McCullough, *supra* note 10, at A1 (discussing HOA rules that rules “forbid ‘offensive conduct,’ defined as ‘activity which in the judgment of the Board of Directors is noxious or offensive to other home lot owners’”) (emphasis added).

14. Goodwyn, *supra* note 3.

15. *Id.*

16. Nick Baumann, *After MoJo Story, Soldier Gets Home Back*, MOTHER JONES (Aug. 19, 2010), <http://www.motherjones.com/mojo/2010/08/michael-clauer-update>.

17. *Id.*

18. Goodwyn, *supra* note 3.

homeowners, the “little Hitlers,”<sup>19</sup> “Hitler’s son[s],” “little Napoleon[s] [sic]” “little trolls,” and “bozos”<sup>20</sup> who run them. Judging by the shape of the major political debates and significant legal scholarship about governance, though, one would be justified in thinking that nothing could be further from the truth; as the California Supreme Court put it, the “existing jurisprudence [on the subject] is not voluminous.”<sup>21</sup> But while a law-abiding person can go through her entire life encountering public government barely more than is necessary to vote, pay taxes, serve on juries, and hopefully receive some social security benefits after her retirement—let alone without being affected by the kinds of questions of federalism and preemption and separation of powers that catch most of the light<sup>22</sup>—a HOA resident will find herself encountering and likely contesting her private government all the time.

The fundamental goal of this Article is to structure and stimulate an interdisciplinary study of the role of courts in reviewing both public and private governance decisions.<sup>23</sup> Much of the study of administrative law is, at some level, attempting to ask and answer this question on the public side, but as some have noted, scholars “almost never treat deference as a subject in and of itself.”<sup>24</sup> This Article endeavors to look at deference as its own subject by developing a set of institutional characteristics relevant to the question of deference and by applying them to the HOA, a particularly powerful private governance institution where the answer to the question of deference seems to have been rendered by state courts without much explanation. Many courts defer almost entirely to HOAs on questions of fact and on the judgments HOAs draw from those facts so long as they act in good faith—borrowing the business judgment rule from the law of corporations—but

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19. McCullough, *supra* note 10, at A1.

20. Christine Haughney, *Beyond Unassuming Walls, a War of Words Among Co-op Board Members*, N.Y. TIMES (May 31, 2010), [http://www.nytimes.com/2010/06/01/nyregion/01appraisal.html?\\_r=0&partner=rss&emc=rss](http://www.nytimes.com/2010/06/01/nyregion/01appraisal.html?_r=0&partner=rss&emc=rss) (error in original). These epithets were actually launched from one board member to another, but they appear to be representative of residents’ relations with their boards as well.

21. *Lamden v. La Jolla Shores Clubdominium Ass’n*, 980 P.2d 940, 947 (Cal. 1999).

22. This is certainly not to say that these do not deserve the attention they receive, but part of the goal of this Article is to suggest that studies of private governance have much to both contribute to and glean from these more well-worn areas.

23. In this effort, this Article follows important first steps which examine the role of courts in HOA governance. See, e.g., Franzese, *supra* note 9; Ellickson, *supra* note 6; Clayton P. Gillette, *Courts, Covenants, and Communities*, 61 U. CHI. L. REV. 1375, 1426 (1994); Gerald E. Frug, *The City as a Legal Concept*, 93 HARV. L. REV. 1059 (1980). These contributions are discussed and engaged with more fully in Part IV.

24. Paul Horwitz, *Three Faces of Deference*, 83 NOTRE DAME L. REV. 1061, 1070 (2008); see also Daniel J. Solove, *The Darkest Domain: Deference, Judicial Review, and the Bill of Rights*, 84 IOWA L. REV. 941, 944–45 (1999) (making similar point).

the reason why is often lacking.<sup>25</sup> In fact, as this Article shows, the institutional characteristics of the HOA make that sort of deference wholly inappropriate.<sup>26</sup> Moreover, while the mismatch may not be so worrisome if the HOA context were nonetheless well-served by the deference rule, the unfortunate truth is that this level of deference distorts institutional and individual incentives in the HOA and creates normatively undesirable decisionmaking.

If we are to treat institutions like HOAs as the powerful governmental entities that they are, it is not unreasonable to demand a deference rule that, if not closely tailored to them, at least fits them relatively well and is designed with their particular processes and characteristics in mind.<sup>27</sup> This Article therefore posits an analogy to an alternate deference framework with institutional characteristics that more closely match the HOA and capture its particular needs: the administrative agency. Importation or adaptation of the major deference rules from federal administrative law, namely the requirement of a process of verifiably reasoned decisionmaking before deference is extended to fact-intensive governance choices,<sup>28</sup> could provide courts with a more appropriate path

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25. Some courts will sometimes use a slightly higher standard of review, that of “reasonableness,” for certain HOA activity like amendments of the community declaration or enforcement of certain covenant restrictions. These courts thus leave the good faith form of deference only for HOA *discretionary actions*. Compare *Nahrstedt v. Lakeside Village Condo. Ass’n*, 878 P.2d 1275 (Cal. 1994) (en banc) (employing reasonableness test for enforceability of covenant restriction banning nearly all pets) and *Mulligan v. Panther Valley Prop. Owners Ass’n*, 766 A.2d 1186 (N.J. Super. Ct. App. Div. 2001) (using reasonableness test for validity of amendments to declaration), with *Levandusky v. One Fifth Ave. Apt. Corp.*, 553 N.E.2d 1317, 1321 (N.Y. 1990) (using business judgment rule to evaluate discretionary board action) and *Lamden v. La Jolla Shores Clubdominium Homeowners Ass’n*, 980 P.2d 940, 942 (Cal. 1999) (same); see also *infra* notes 47–57 and accompanying text (discussing *Nahrstedt*, *Levandusky*, and *Lamden*). To the extent that a state uses the business judgment rule in only certain contexts, namely to evaluate discretionary action, the insights drawn from this Article certainly remain applicable, just in those contexts. Further, the administrative agency analogy offered in Part IV could well be a superior alternative to the reasonableness test too.

26. In *Common Interest Communities: Standards of Review and Review of Standards*, Paula Franzese also questions the applicability of this level of deference. See Franzese, *supra* note 9. Though she does note that, as this Article illustrates, the characteristics of the corporation and the HOA are “decidedly different,” she does not engage in the sort of institutional analysis that is the heart of this Article. *Id.* at 668 (quoting WAYNE S. HYATT & SUSAN F. FRENCH, *COMMUNITY ASSOCIATION LAW* 299 (1998)). Indeed, perhaps even more than the specific question of how to review the decisions of homeowners associations, this Article is motivated by the broader need to explore the role of courts in ordering private governance and governmental incentives based on the structure of the given institution, with homeowners associations as a case study. She also embraces a “multi-factored reasonableness test” rather than the administrative analogy that is offered here and that is descriptively and normatively superior, as Part IV discusses.

27. In employing this premise, this Article builds off the notion that courts often allocate decisionmaking based on the attributes of the relevant institutional decisionmakers. See generally Neil K. Komisar, *Taking Institutions Seriously: Introduction to a Strategy for Constitutional Analysis*, 51 U. CHI. L. REV. 366 (1983). As Komisar explains, this approach is often employed in the political science literature. *Id.* at 368 n.2 (collecting sources).

28. *E.g.*, *Allentown Mack Sales & Servs. v. NLRB*, 522 U.S. 359 (1998); *Motor Vehicle Mfrs.*

for addressing HOAs on their terms, or at least on terms far closer to their own.<sup>29</sup> This would therefore be a descriptively more appropriate, and a normatively more desirable, deference regime. At the very least, these insights from administrative law could be used to begin a more serious reexamination of judicial treatment of HOAs—and, more broadly, to rethink judicial approaches to other private governance institutions.<sup>30</sup>

This Article proceeds in three major parts. Part II sets out the characteristics of the HOA and presents the current deference doctrine, its foundational premises in the law of corporations, and its application to the HOA context. Part III develops a set of elements central to determining both the need for and degree of external oversight of a governing entity: the internal opportunities and substitutes for accountability in the forms of exit, voice, and expertise; the rights presumed to be retained and the impacts likely to be created by governmental action; and the levels of diversity of interests. It then assesses the corporate firm and the HOA on each of those metrics and illustrates just how distinct the entities are—revealing the impropriety of applying the business judgment rule to the latter. Drawing on these conclusions, it engages with the practical and normative implications of this mismatch to show that the application of the business judgment rule produces undesirable incentive structures in the HOA context. Part IV briefly examines alternate approaches offered in the literature before exploring the similarities between administrative agencies and HOAs along the same set of institutional elements employed in Part III. It posits that the analogy between HOAs and administrative agencies could be a fruitful source of new thinking about HOAs, and suggests that adaptation of administrative deference rules to the HOA context is normatively desirable in that it could lead to better HOA governance. Finally, the Article concludes by suggesting that breaking down the public–private divide in the study of judicial deference and approaching the problem from this sort of interdisciplinary perspective could lead to more creative and institutionally appropriate approaches to all manner of

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Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29 (1983).

29. In a student Note, David Drewes similarly suggested that courts employ some procedural review of HOA decisions. David C. Drewes, Note, *Putting the 'Community' Back in Common Interest Communities: A Proposal for Participation-Enhancing Procedural Review*, 101 COLUM. L. REV. 314, 338–41 (2001). But Drewes does not tie this proposal to the existing structure of deference to administrative agencies or to the institutional similarities between HOAs and those agencies, further illustrating the doctrinal isolation of this issue that this Article seeks to remedy.

30. Glen Staszewski similarly has drawn on insights from administrative law in his study of another form of governance: direct democracy. See generally Glen Staszewski, *Rejecting the Myth of Popular Sovereignty and Applying an Agency Model to Direct Democracy*, 56 VAND. L. REV. 395 (2003).

private governance institutions.

## II. THE HOA AND DEFERENCE UNDER THE BUSINESS JUDGMENT RULE

The HOA is a specialized form of residential development. Ordinarily, property developers subdivide large tracts of land into individual parcels and then sell those parcels to individual home buyers. Indeed, that phenomenon is the source of today's suburbs, all of which were once characterized by larger plots of land held by fewer people. But in the HOA, also sometimes called a "common interest community," the subdividing developer also imposes a comprehensive system of covenants running with the land—a set of conditions on the units within the development that the developer expects will draw potential buyers, like certain standards of exterior upkeep or bans on certain uses of property, and that the developer wants to ensure will persist into the future.<sup>31</sup> Moreover, the developer usually creates a governing board to enforce those conditions, set community policy, and, in most cases, collect fees for community expenses and levy assessments for community-wide capital improvements. The developer enumerates these restrictions and organizes the HOA board in a declaration—akin to the community's constitution—which is filed with the county recording office in the same manner in which deeds and other covenants are filed, before the sale of any units. Recordation thus puts potential buyers on notice of the restrictions in the community, the powers of the board, and the costs of membership, and thereby binds buyers to obey.<sup>32</sup>

Because no document can anticipate every aspect of the future, the HOA functions as the government of the community. It enforces rules, adjudicates disputes, metes out punishment, appropriates money, and from time to time, enacts new restrictions or amends old ones. A great deal of governance and decisionmaking thus takes place inside a HOA, and since governing invariably produces losers or dissatisfaction, homeowners often seek judicial recourse for HOA action which harms them or with which they disagree.

When courts review HOA decisionmaking, they tend to borrow the business judgment rule from the law of corporations and defer to the HOA in nearly all cases.<sup>33</sup> As it is a creature of state law, the precise

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31. See Franzese, *supra* note 9, at 671 ("Restrictions on use are an integral, essential aspect of any common interest community, generally regarded as vital to preserving the stable, planned environment that shared ownership aims to foster.").

32. See *id.* at 672–73 (discussing HOA declarations and board powers).

33. Some courts have used a "reasonableness" test, which may be taken to mean a more searching review. See *supra* note 25 and accompanying text (discussing use of reasonableness test);

formulations of the business judgment rule may vary slightly across state courts, but in general, a court will not second-guess the choices made by a corporate board unless the board acted in bad faith—for a reckless, disloyal, or other non-firm-regarding reason.<sup>34</sup> Moreover, the burden is on the challenger to demonstrate one of these impermissible purposes, so the presumption is in all cases that a board acts in good faith.<sup>35</sup>

And it is a presumption that is incredibly difficult to overcome. For example, courts reviewing action in the corporate context have been quite clear that a shareholder challenging corporate activity must show “more than imprudence or mistaken judgment,”<sup>36</sup> even if the board’s mistake in judgment was beyond question and even if the board is unable to offer so much as a post hoc rational basis for its decision. As one court has put it, “the authority of the directors in the conduct of the business of the corporation must be regarded as *absolute* when they act within the law . . . .”<sup>37</sup> Observe that this logic thus suggests a level of deference even stronger than the “rational basis” deference that acts of a public legislature routinely receive. While rational basis review is a very permissive standard, requiring merely that some plausible rational basis could be conjured at trial to support the legislation, the business judgment rule does not even require that much. Instead, absent evidence of a breach of fiduciary duties,<sup>38</sup> courts suggest merely “political”

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*infra* notes 53–57 and accompanying text (discussing *Nahrstedt*). However, many of these purportedly more searching opinions, e.g., *Bernardo Villas Mgmt. Corp. No. Two v. Black*, 190 Cal. App. 3d 153 (Ct. App. 1987) (finding for defendant homeowner that application of rule to situation was unreasonable); *Baum v. Ryerson Towers*, 55 Misc. 2d 1045 (N.Y. Sup. Ct. 1968) (same), were issued by the very same courts that, as discussed here, have since embraced the business judgment rule as the appropriate form of deference in the same contexts, or at least for other equally salient HOA activity, e.g., *Levandusky v. One Fifth Ave. Apt. Corp.*, 553 N.E.2d 1317, 1321 (N.Y. 1990) (applying business judgment rule); *Lamden v. La Jolla Shores Clubdominium Homeowners Ass’n*, 980 P.2d 940, 942 (Cal. 1999) (same). Moreover, some scholars doubt the very consistency of courts’ uses of the reasonableness standard itself. See Gregory S. Alexander, *Dilemmas of Group Autonomy: Residential Associations and Community*, 75 CORNELL L. REV. 1, 13 (1989) (“The character of judicial review of residential association restrictions under the reasonableness requirement is far less clear than these critics recognize. There simply is no general pattern or model that emerges from the cases applying the reasonableness standard. While some decisions appear to involve substantive review, courts in other cases [in those same states] have followed . . . a minimalist review . . .”).

34. See, e.g., *Liebman v. Auto Strop Co.*, 150 N.E. 505, 506 (N.Y. 1926) (“Courts will not interfere with [board discretion] unless it be first made to appear that the directors have acted or are about to act in bad faith and for a dishonest purpose.”).

35. See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (discussing “presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith . . .”).

36. *Kamin v. Am. Express Co.*, 86 Misc.2d 809, 813 (N.Y. Sup. Ct. 1976), *aff’d*, 54 A.D.2d 654 (N.Y. App. Div. 1976).

37. *Shlensky v. Wrigley*, 95 Ill.App.2d 173, 179 (1968) (quoting *Toebelman v. Mo-Kan. Pipe Line Co.*, 41 F. Supp 334, 339 (D. Del. 1941)) (emphasis added).

38. In the rare case, a misguided board may even admit that it acted for some reason other than

solutions for disgruntled shareholders: lobby the directors to take alternative measures or vote them out in retaliation.<sup>39</sup>

The business judgment rule is thus a nearly free pass for boards of directors as long as a challenger lacks proof of disloyalty or bad faith. When applied in the HOA context, the same result follows. One of the early cases to follow this pattern was a Colorado Court of Appeals decision called *Rywalt v. Writer Corp.* in which the plaintiff homeowners sought an injunction against the HOA's decision to build a second tennis court on community property but near the plaintiffs' property line. At trial, the court had granted the injunction, finding that the HOA board had failed to keep complete minutes of meetings, hold public meetings, or take a proper poll of the community, and that it had acted in a substantively arbitrary fashion by failing to consider alternative spending priorities like addressing parking and sanitation inadequacies. On appeal, however, the court vacated the injunction, imposing no such procedural requirement and simply stating that "[t]he good faith acts of directors of profit or non-profit corporations . . . within the exercise of an honest business judgment are valid" and that "[c]ourts will not . . . interfere with or regulate the conduct of the directors in the reasonable and honest exercise of their judgment and duties."<sup>40</sup>

This is exactly the language of the business judgment rule, and yet the *Rywalt* opinion contains no discussion of why that rule should apply to a HOA. In fact, the cases it cites are all ordinary corporations cases<sup>41</sup> and the secondary legal materials it cites are all corporations treatises.<sup>42</sup> Perhaps the court simply assumed (although it never said anything about it) that because the HOA is nominally a corporation, the business judgment rule should apply. As will be discussed in Part III, though, the HOA is a fundamentally different creature, and more than a bare assertion of analogy is needed to support applying that deference rule. In the end, because the plaintiffs did not and could not make out a claim of bad faith, their loss was all but inevitable once that standard of review was adopted.

A few years later, a New Jersey court considered the claim of a group of owners, not unlike the Clauers of Texas, who sought to enjoin their

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the financial growth of the firm. See *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919) (conferring no deference because company president Henry Ford admitted he had acted for philanthropic reasons, not solely to protect and increase "the profit of the stockholders").

39. See, e.g., *Kamin*, 86 Misc.2d at 812.

40. *Rywalt v. Writer Corp.*, 526 P.2d 316, 317 (Colo. Ct. App. 1974).

41. *Id.* (citing *Taylor v. Axton-Fisher Tobacco Co.*, 173 S.W.2d 377 (Ky. 1943) (involving corporate board's decision to call certain class of stock); *Horst v. Traudt*, 96 P. 259 (Colo. 1908) (involving actions of nonprofit corporation)).

42. *Id.* (citing 19 AM. JUR. 2D CORPORATIONS § 1148; 19 C.J.S. CORPORATIONS § 984).

HOA board from asserting a lien against them for nonpayment of a levied special assessment. In *Papalexiou*, the court denied their request and explained that the same test used to evaluate the actions of a corporation “also applies” to that of HOA boards and that it requires “simply an application of the ‘business judgment rule’” to find that, absent the plaintiffs’ showing a lack of good faith on the part of the board, the board’s decision “should not be judicially reviewed.”<sup>43</sup> In fact, not only did the court go on to cite a corporations treatise, it cited one of the corporate law cases discussed above.<sup>44</sup> Similarly, in *Tiffany Plaza*, a Florida appeals court deferred to the “good business judgment” of the HOA board.<sup>45</sup> Finally, the Court of Appeals and Supreme Court of South Carolina both relied on *Papalexiou* and *Tiffany Plaza* in brief opinions holding that “the business judgment rule precludes judicial review of actions taken by a corporate governing board absent a showing of a lack of good faith . . . .”<sup>46</sup> This is a factually accurate statement, but its relevance to the HOA case before the court is, as in *Rywalt*, simply not made apparent.

Courts in New York and California have, to their credit, engaged in a more searching inquiry into the propriety of the application of the business judgment rule to HOAs. In both states, the highest courts have stated that the business judgment rule should *not* directly apply. But they went on to apply it anyway “for the purpose of analogy” and with the same content and results.<sup>47</sup>

In the New York case, *Levandusky*, the Court of Appeals began by recognizing the fact that a HOA is not simply an ordinary corporation. Instead, the court viewed it as a “quasi-government,” albeit a voluntary one, the evaluation of which required “sensitiv[ity]” to the unique situation and balancing the need for some check on the board with the freedom to act that a quasi-governmental body like the HOA deserves.<sup>48</sup> It also expressed awareness of the business judgment rule’s “origins in the quite different world of commerce,” though it focused on what it

43. *Papalexiou v. Tower West Condo.*, 401 A.2d 280, 285–86 (N.J. Super. Ct. Ch. Div. 1979).

44. *Id.* at 286 (citing HENN, *LAW OF CORPORATIONS* 482–83 (2d ed. 1970), § 242; *Shlensky v. Wrigley*, 95 Ill.App.2d 173 (App. Ct. 1968)).

45. *Tiffany Plaza Condo. Ass’n v. Spencer*, 416 So.2d 823, 826 (Fla. Dist. Ct. App. 1982). Note that the court in *Tiffany Plaza* relied on language in the community declaration discussing the application of the business judgment rule to the decisions of the board, but the fact that the court simply accepted it as the proper standard of review is illustrative of the general pattern in these cases. Moreover, *Tiffany Plaza* has been relied on for its endorsement of applying the business judgment rule. *E.g.*, *Dockside Ass’n v. Deytens*, 352 S.E.2d 714, 716 (S.C. Ct. App. 1987).

46. *Dockside Ass’n v. Deytens*, 362 S.E.2d 874, 874 (S.C. 1987) (citing *Papalexiou*); *see Dockside Ass’n*, 352 S.E.2d at 716 (citing *Papalexiou* and *Tiffany Plaza*).

47. *Levandusky v. One Fifth Ave. Apt. Corp.*, 553 N.E.2d 1317, 1321 (N.Y. 1990).

48. *Id.*

imagined would be differences in fiduciary obligations.<sup>49</sup> As Parts III and IV explore, this is a far better assessment of the HOA than was the assumption in the other cases discussed above that a HOA is essentially a corporation, but it is just the tip of the iceberg. However, the court cited those exact cases, specifically *Rywalt* and *Papalexidou*, and “agree[d] with those courts” about the appropriate level of deference anyway.<sup>50</sup> Indeed, if it thought it was contributing something new to the conversation with its discussion of the uniqueness of HOAs, it was only introducing confusion and a new “analogic” title for what is essentially business judgment rule deference itself: “So long as the board acts for the purposes of the cooperative, within the scope of its authority and in good faith, courts will not substitute their judgment for the board’s.”<sup>51</sup> To be more charitable, the court did recognize that the contexts are different, but it appears to have concluded that any other deference rule would be inferior to or more confusing than the business judgment rule.<sup>52</sup>

This brief survey of the doctrine ends in California, where the California Supreme Court held in *Lamden* that the appropriate deference rule was identical to that used by the New York Court of Appeals in *Levandusky*: a board acting in “good faith and with regard for the best interests of the community association and its members” is entitled to deference.<sup>53</sup> The court insisted, however, that it was rejecting the “direct” application of the business judgment rule because that rule protects directors from liability rather than protecting a board from an injunction, and because this particular association happened not to be incorporated.<sup>54</sup> This is certainly true and, like the *Levandusky* court’s discussion of the differences between contexts, this awareness of the difference in remedy is an important one that will be returned to in Part III(C) of this Article. However, the court in *Lamden* failed to appreciate what that contextual difference signified. Despite recognizing the difference, the court deferred generously nonetheless, adopting a standard that is indistinguishable from the business judgment rule as applied in other states.

*Lamden* also reveals an important nuance. Just a few years earlier, that same court had held in *Nahrstedt* that reasonableness was the

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49. *Id.*

50. *Id.*

51. *Id.* at 1322.

52. *Id.* at 1324 (describing application of business judgment rule as “striking the best balance”). Part III(C), *infra*, demonstrates that this rule actually produces poor incentives and poor governance in the HOA context.

53. *Lamden v. La Jolla Shores Clubdominium Homeowners Ass’n*, 980 P.2d 940, 942 (Cal. 1999).

54. *Id.* at 945.

appropriate standard for evaluating the enforceability of covenant restrictions—a slightly higher standard than the nearly empty standard of “good faith” later used in *Lamden*.<sup>55</sup> But the *Lamden* court distinguished *Nahrstedt*, such that *Lamden* “did not disturb [the reasonableness] formulation but found it inapplicable to the matter at bar, which involved the standard for judicial review of discretionary economic decisions made by the governing board.”<sup>56</sup> For those governance types of HOA decisions, the court rejected the plaintiff’s arguments for a more searching review because it saw benefits in application of the business judgment rule: respect for the expertise of the HOA boards, “certainty and predictability in the governance and management” of HOAs, and incentives for residents to participate more vocally in the political mechanics and decisions of HOAs.<sup>57</sup> *Lamden* thus illustrates that even those states that use a reasonableness standard in certain contexts may retain the business judgment rule in others, specifically those dealing with HOA decisionmaking.

The issues raised in *Lamden*—voice and accountability, effective management of the interests of the community, and HOA expertise—are precisely the correct issues to examine when evaluating both the context in which a deference rule is to be applied and the implications of that deference rule. In identifying them, at least, the *Lamden* Court was quite right, and did much better than the courts in Colorado, New Jersey, Florida, South Carolina, New York, and many other states. Unfortunately, it assessed these issues incorrectly, or at least insufficiently. The rest of this Article builds on these characteristics to engage in a deeper institutional analysis and to identify a more appropriate deference regime.

### III. THE INSTITUTIONAL MISMATCH: HOAs AND CORPORATIONS

#### A. Institutional Characteristics and Judicial Deference

To determine whether and in what ways HOAs and corporations are or are not alike, it is important to first develop a set of characteristics across which the two should be compared for the purpose of evaluating the appropriate standard of judicial review. It is of little help, after all, to say that HOAs are sometimes legally incorporated, just like corporations, or that many corporations often produce a good or service for the market, unlike HOAs, without any sense of why these things

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55. *Nahrstedt v. Lakeside Village Condo. Ass’n*, 878 P.2d 1275 (Cal. 1994) (en banc).

56. Franzese, *supra* note 9, at 680.

57. *Lamden*, 980 P.2d at 954.

might be relevant for understanding the organization's governance structures and, consequently, determining the right level of judicial deference.

While there are certainly a myriad of possible characteristics that could influence the scope of deference, they would all likely fall under two central questions: How accountable is the governing entity to those it governs, and, if it is not particularly accountable to them, how much do we care about that lack of accountability?<sup>58</sup> That accountability is the place to start is made clear by adverting to classic theories of separation of powers and judicial review. Ordinarily, legislation emanating from Congress or other public legislatures is reviewed only for a "rational basis" exactly because that legislature is more accountable to the public than are unelected or term-protected courts.<sup>59</sup> Put another way, this is the classic "countermajoritarian difficulty" identified by Alexander Bickel: Because courts are unelected, when they reverse legislation, they act contrary to the wishes of the majority.<sup>60</sup> This claim, however, is premised on the idea that the legislature actually represents the majority. To the extent that it is not accountable to its constituents, the governing entity loses its prime advantage over courts and opens itself to more searching review. Moreover, internal accountability mechanisms diminish the need for an external check to keep the institution in line. It is when those governed by the institution cannot effectively take advantage of political solutions to make the institution work to their benefit that the courts become a necessary last resort.<sup>61</sup>

Accountability has two faces. The first and most straightforward is exit. As economist Albert Hirschman outlined in his pioneering work on institutions and loyalty, exit is essentially the means by which competition takes place.<sup>62</sup> As a result, it is the sharpest way for

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58. *Cf. Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 865–66 (1984) (considering accountability and expertise when determining scope of deference).

59. *See Williamson v. Lee Optical of Okla.*, 348 U.S. 483 (1955). Of course, this standard only applies absent some suspect classification or infringement on a fundamental right. *United States v. Carolene Prods. Co.*, 304 U.S. 144, 152 n.4 (1938).

60. *See generally* ALEXANDER M. BICKEL, *THE LEAST DANGEROUS BRANCH: THE SUPREME COURT AT THE BAR OF POLITICS* (1962).

61. *Cf. Baker v. Carr*, 369 U.S. 186, 258–59 (1962) (Clark, J., concurring) ("I would not consider intervention by this Court into so delicate a field [of legislative apportionment] if there were any other relief available to the people of Tennessee. But the majority of the people of Tennessee have no practical opportunities for exerting their political weight at the polls' to correct the existing 'invidious discrimination.' Tennessee has no initiative and referendum . . . . The majority of the voters have been caught up in a legislative strait jacket . . . . We therefore must conclude that the people of Tennessee are stymied and without judicial intervention will be saddled with the present discrimination in the affairs of their state government.").

62. ALBERT O. HIRSCHMAN, *EXIT, VOICE, AND LOYALTY* 21 (1970).

consumers or members to send a message to a producer or organization that something is wrong, that they are dissatisfied, and that they would like to see a change. When customers exit by, say, suddenly ceasing to patronize a restaurant, the restaurateur will acutely feel the effect to his bottom line and set about trying to determine what went wrong and to remedying it. This principle is by no means limited to the market. After all, when an incumbent president observes that the voters have abandoned his party in midterm congressional elections, he internalizes the “shellacking,” as President Obama famously put it, and attempts to adjust goals, policies, or practices accordingly.<sup>63</sup>

In order for exit to function as a mechanism of feedback and accountability, though, exit must be possible. Our restaurateur may not know that his customers hate his restaurant if the nearest restaurant is an hour’s drive away or is so incomparable to his own as to be a poor experimental control. And in order for exit to function *well* as an accountability mechanism, fast exit must be easy; otherwise, a timing gap between the odious action and the exit makes it less clear to the restaurateur that the exit was caused by that particular action. These conclusions are captured by the concept of demand elasticity. The greater the number of substitutes and the easier it is to stop consuming a good and to start consuming the substitute, the more elastic demand is. In the limit, people will never have to put up with any displeasure at all, as the slightest misstep by the firm or institution will trigger a stampede away from that institution. If, on the other hand, people have no easy outside option, demand is highly inelastic; people will have to put up with a lot of displeasure, “and the firm will not get the message that something is amiss.”<sup>64</sup> Ease of exit is thus a key piece of an institution’s accountability.

The other face of accountability is voice. If people cannot easily express their displeasure by voting with their feet, then the only other option is to do so vocally by working inside the failing institution and making “an attempt at changing the practices, policies, and outputs” of the institution “rather than . . . escap[ing] it.”<sup>65</sup> Like exit, opportunities for voice exist along a continuum: a dictatorship being all but defined by the lack of voice in the institution and a consensus-based community or a true republic by the centrality of the voice of the people. And like exit, voice must be more than a formality to trigger accountability. The leadership must be willing to listen when voice is exercised, and those seeking to exercise voice need points of institutional access. Just as the

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63. Peter Baker & Carl Hulse, *Deep Rifts Divide Obama and Republicans*, N.Y. TIMES (Nov. 3, 2010), <http://www.nytimes.com/2010/11/04/us/politics/04elect.html>.

64. HIRSCHMAN, *supra* note 62, at 24.

65. *Id.* at 30.

ease and availability of substitutes is key to the exercise of exit, the probability of actually influencing decisions is key to the exercise of voice. Because exercising voice is costly—in time, money, potentially goodwill, and the need to overcome collective action problems inherent in effecting change<sup>66</sup>—only a person with a lot to lose would bother undertaking those costs in the face of a highly improbable chance of being meaningfully heard.<sup>67</sup> That I may not like the new taste of a popular cookie is likely not going to motivate me to petition Nabisco to change it. Knowing that one letter from me will not make Nabisco change its cookies, and knowing that I have better things to do than organizing a march on Nabisco headquarters or undertaking the costs of putting together a larger lobbying effort, I will eat a subpar Nabisco cookie if there is no other option, or I will exit (cease buying Nabisco cookies) and buy another cookie instead.

As this discussion illustrates, exit and voice are two sides of accountability, each becoming the primary hope of a dissatisfied constituent where the other leaves off. Where both are effective, a person will weigh the likelihood of success and the resources needed to achieve it before choosing one (or both), but that the choice is available indicates that the institution is quite accountable. Where just one is effective, the accountability of the institution turns entirely on how effective that one is. Where neither are effective, the institution is internally unaccountable.

Recall that this entire discussion is not just about institutions, though, but about the judiciary's relationship to those institutions. Because judicial deference is "predicated on an assumption that those who make decisions . . . are representative of the association's members," the extent to which that accountability exists is a critical question when evaluating that relationship.<sup>68</sup> While accountability is the paramount factor, though, the lack of such accountability alone does not necessarily require that courts employ a more searching review or that they decline to defer to the judgments made by a given institution. In fact, we may accept certain substitutes for accountability, or we may think that the impact of that unaccountability is so weak or is mitigated in other ways such that judicial interference would, on balance, do more harm than good.

One main substitute for accountability is expertise: one may be comfortable with unaccountable leadership if one trusted that there were

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66. See *id.* at 39 (discussing costs of voice).

67. See EDWARD C. BANFIELD, *POLITICAL INFLUENCE* 333 (1961) ("The effort an interested party makes to put its case before the decision-maker will be in proportion to *the advantage to be gained from a favorable outcome multiplied by the probability of influencing the decision.*").

68. Gillette, *supra* note 23, at 1426.

right and wrong answers, and that the leadership was so expert that it would truly know which were which far better than the governed ever could.<sup>69</sup> In this context, accountability could actually be *undesirable* in that it would mean that important technical or scientific decisions would be made by laypeople who had little understanding of the issues. That the Federal Reserve Bank and similarly expert institutions are more unaccountable even than the average administrative agency, since its leaders do not simply serve at the pleasure of the president, is often presented as an important and salutary feature. Moreover, the fact that the institution exercising review—the courts—is also unaccountable and even less expert makes judicial oversight of an expert institution especially unattractive. Indeed, courts defer to administrative agencies in large part because those agencies have more technical expertise in the subject matter than do the courts themselves.<sup>70</sup>

Even an unaccountable and non-expert institution may still claim to be entitled to judicial deference, or a court may still properly choose to defer to such an institution, if the impact of that institution's decisions is relatively small or if the interests of the governed are such that the likelihood of making a decision with non-uniform effects is small. The first piece, referred to here as "impact range," captures the expectations of the governed: if the constituent has little to lose or if she has already shed a significant number of rights, like a student in a public secondary school, then insofar as the governmental action affects those non-retained rights, deference could remain justified even if the governmental entity were neither accountable nor expert. Moreover, at a certain level, concerns for judicial economy simply demand that courts decline a more searching review and adopt a deference rule that allows them to decide cases easily when the consequences of the governmental body's actions are minor. The relationship of the second piece, homogeneity of constituent interests, to the question of deference may be less immediately apparent, but the more heterogeneous is the constituency, the more complex the demands are on the governing entity. Because of that complexity, it is more likely that voice will fail to discipline the institution because it is internally divided; that a majority will attempt to take advantage of a "discrete and insular

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69. See Jeffrey J. Rachlinski & Cynthia R. Farina, *Cognitive Psychology and Optimal Government Design*, 87 CORNELL L. REV. 549, 558–60 (2002) (discussing benefits of expertise in institutional decisionmaking).

70. See, e.g., *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 865–66 (1984) (discussing importance of agency expertise relative to judicial expertise); Patrick M. Garry, *Accommodating the Administrative State: The Interrelationship Between the Chevron and Nondelegation Doctrines*, 38 ARIZ. ST. L.J. 921, 943 (2006) (noting that *Chevron* deference is justified in part by agencies' "specialized or technical expertise in the subject matter").

minority,”<sup>71</sup> to allude to the language of strict scrutiny in the Fourteenth Amendment context; or that a special interest minority will capture the institution. Each of these possibilities could justify greater judicial interference, and when the likelihood that one of these situations would arise inheres in a given institution as a result of the structure of its constituents’ interests, it makes less sense to adopt the judicial shortcut of deference. At the very least, when competing interests exist, there is a stronger argument that a court should limit the extent of its deference absent other procedural safeguards.

These five characteristics represent a cascade of institutional safeguards against pervasive, dangerous, and rogue governance action. The more of them that are present, the less necessary is external oversight and the more justified is judicial deference. The first two, exit and voice, are related pieces of an accountability check by which the constituents themselves can police the institution. The third, expertise, may substitute for true accountability and thus justify its absence. The fourth and fifth, impact range and homogeneity of interests, may alleviate concerns about the lack of accountability or expertise by providing some confidence that any rogue action will not be too dangerous and does not require additional oversight as a general rule. The first three have certainly been considered by courts in developing existing deference rules, like those of the federal administrative state, and while the last two are rooted more in analogy to other doctrines, they represent an intuition about the hazard of drawing generalizations or abstaining from external review in complex situations. In the next Subpart, this Article evaluates corporations and HOAs under these five characteristics so as to reveal the relevant differences between them and the consequences for deference.

### *B. Evaluating HOAs and Corporations*

#### 1. Exit

The first key governance characteristic is the availability of exit—the first face of accountability. In the publicly traded firm, constituent exit is quite easy. All the constituent—a shareholder—must do is divest by selling her shares on the open market. It does not even take a phone call to a stock broker to do this anymore; with a click of a mouse, anyone can buy and sell stock. Transaction costs are *de minimis*, and as a result, people do it millions of times a day. Few feel any real sense of brand loyalty to a given stock; if it is not performing well, they divest and take

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71. *United States v. Carolene Prods. Co.*, 304 U.S. 144, 152 n.4 (1938).

their money elsewhere. An individual's demand for each individual corporation's stock is thus highly elastic, and because corporations know that a major error can cause dramatic losses, they are disciplined ex ante by the danger of losing investors. The value of stock in BP, for example, dropped steadily by more than 50% following the 2010 explosion of the Deepwater Horizon oil rig and throughout the subsequent two months of repeated failures to seal the massive leak.<sup>72</sup> Similarly, on news of a jury verdict of over \$1 billion against Samsung in a major patent infringement lawsuit filed by Apple, Samsung lost over \$12 billion in market value as its overseas stock price dropped by 7.5% nearly overnight—its biggest daily percentage drop in four years.<sup>73</sup>

To be sure, mutual funds, pension funds, and the like—all of which are more heavily invested in a given stock than the average individual stockholder—may face a different set of concerns and a set of higher or more complicated transaction costs. However, even their ability to exit remains on the easy end of the spectrum, compared to the diners at the lone restaurant in town or even to voters, who must wait two or four or six years before they can “exit” by voting for someone else.<sup>74</sup> More importantly, this likely difference in an institutional shareholder's exit reaction itself helps make exit a more effective form of discipline. Precisely because of the low transaction costs and the highly fluid means of exit, it would be possible that a corporation would not have time to learn from its mistakes if every investor exited. In other words, ex post discipline may be hard to come by if corporations simply collapsed as a result of mistakes that alienated all the shareholders. This is why Hirschman notes that, for exit to effectively discipline a corporation, there must be a combination of “alert and inert” constituents: some who will leave and send the message, and some who will stay, wait for improvement, and give the corporation time to solve the problem.<sup>75</sup> In the shareholder context, this condition exists, thanks to those institutional shareholders. By and large, they serve the role of the inert constituent, in contrast to the highly alert day trader who may

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72. When the leak was capped, though, the stock quickly and almost immediately began to rebound, further illustrating the elasticity of demand. See BP Common Stock, YAHOO! FINANCE, <http://finance.yahoo.com/echarts?s=BP+Interactive#symbol=bp;range=20100107,20110905;compare=;indicator=volume;charttype=line;crosshair=on;ohlvalues=0;logscale=on;source=undefined>.

73. Miyoung Kim, *Samsung Shares Drop \$12 Billion After Apple's Court Victory*, REUTERS (Aug. 27, 2012), <http://in.reuters.com/article/2012/08/27/us-samsung-shares-idINBRE87Q00120120827>.

74. Moreover, to the extent that exit is less immediately attractive for institutional shareholders, they are compensated in terms of accountability options by stronger access to voice, as will be discussed in the next Subpart. And it is the fact that exit remains an option that provides them with a credible threat with which to leverage compliance with demands made in that exercise of voice.

75. HIRSCHMAN, *supra* note 62, at 24 (emphasis omitted).

exit at the slightest bad sign. As a result, the prospect of exit not only disciplines corporations *ex ante*, but exit itself can discipline corporations *ex post* because of the combination of alert and inert constituents.

In a HOA, by contrast, exit is always difficult—at times prohibitively so—and is therefore a poor source of accountability either *ex ante* or *ex post*. First, selling a home is not nearly as fast or simple a process as selling some shares of stock. One must often involve (and pay for) brokers, lawyers, and paperwork. One must also *find* a buyer, and locate and buy another home to move into. All of this is expensive. This may sound like an obvious point, but it is critical to understanding the significant obstacles faced by a dissatisfied constituent in a HOA seeking to use exit as a means of accountability. Second, selling a home is costly in non-financial ways as well. As with any home and community, people develop a “sense of belonging.”<sup>76</sup> They build memories in their homes; they may mark their children’s heights on a sheetrock wall in the basement, or they may grow attached to the view from the front porch. Moreover, they tie themselves into the surrounding community by enrolling their children in the local public school or attending a nearby church or synagogue. In the HOA context, these ties may be particularly significant because most HOAs also have a variety of community organizations—sports leagues, card games, bingo tournaments—of which residents are often members. These kinds of emotional costs are not to be minimized. In fact, the petitioners in the famous eminent domain case, *Kelo v. City of New London*, were eulogized by the dissenting justices as having lost the homes in which they lived for “over 100 years” or “in the house he received as a wedding gift.”<sup>77</sup> Even the majority, rejecting petitioners’ claims, was moved to note that one of the petitioners “ha[d] made extensive improvements to her house” that she treasured, and that she “prize[d] its water view.”<sup>78</sup> No one could say that an ordinary shareholder possesses the degree of emotional connection to his or her shares in a particular corporation that he does to his home.

In other words, as Gregory Alexander has observed, exit from HOAs is quite costly because “residents, having made substantial investments in purchasing their units, are to a considerable extent locked in.”<sup>79</sup> They are *all*, to return to Hirschman’s formulation, fairly inert constituents as a result of these transaction costs. There is also reason to believe they

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76. Alexander, *supra* note 33, at 41.

77. *Kelo v. City of New London*, 545 U.S. 469, 494–95 (2005) (O’Connor, J., dissenting).

78. *Id.* at 475 (Stevens, J., majority).

79. Gregory S. Alexander, *Conditions of “Voice”: Passivity, Disappointment, and Democracy in Homeowner Associations*, in *COMMON INTEREST COMMUNITIES*, *supra* note 9, at 145, 153.

may be more inert sorts of people generally, because “people who purchase [homes] generally have a stronger preference for residential stability than do nonpurchasers” like renters.<sup>80</sup> Put another way, it will take an awful lot of dissatisfaction to drive a homeowner to exit a HOA. The mix of mobile/alert and inert constituents that is so critical to the effectiveness of exit as a means of accountability is thus lost in the HOA. At the very least, the threshold is significantly higher in the HOA context than it is for a corporation, which means, charitably, that much more dissatisfaction will go unnoticed by a HOA board than by a corporate board because the signaling device is weaker. Less charitably, more dissatisfaction will go *uncorrected* by a HOA board because it knows that it can get away with a lot of it without losing residents. It is also not entirely clear how much a board would care about losing residents. Even if a resident got fed up and left, a buyer would replace her, and would likely do so unaware of the full scope of the underlying rules and, perhaps more importantly, of the discontent.<sup>81</sup> After all, the seller would be the chief source of this kind of information for the buyer, but the seller would obviously want to conceal as much dissatisfaction as possible so as to encourage the buyer to buy the house. It would thus take significant, widespread, *public* dissatisfaction informing potential new entrants—to the level of dissuading them from buying—to make the board “feel” disciplined. And even at that point, the board’s need to be responsive to exit is questionable—perhaps triggered only once community dissatisfaction drives down their own property values. Simply put, in terms of the accountability provided by exit, the HOA and the corporation are worlds apart.

## 2. Voice

As the second face of accountability, voice, while always valuable, is most important when exit is difficult—just as exit is most critical when exercising voice is difficult. In both the publicly traded firm and the HOA, exercising voice is not easy and is rarely done, but because the corporation is characterized by such fluid exit, this failing does not make the corporation unaccountable and undeserving of the judicial deference

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80. *Id.* at 162–63.

81. See Fennell, *supra* note 5, at 876 (“[M]ost people who buy into private communities do not fully understand what they are getting into. If home purchases arise from misunderstandings, then they cannot provide meaningful market signals . . .”); James L. Winokur, *Choice, Consent, and Citizenship in Common Interest Communities*, in *COMMON INTEREST COMMUNITIES*, *supra* note 9, at 87, 99–101 (noting that evidence “suggests that few prospective owners intelligently review the restrictions” when they buy, that “documentation typically makes long, boring reading for laypersons,” and that “even those who read the restrictions in advance may miscalculate their own future attitudes toward servitude restrictions over time”).

contained in the business judgment rule. Because exit from the HOA is so tough, however, the failure of voice to also function as an effective check only deepens the HOA's unaccountability and further suggests the inappropriateness of applying the corporation's deference rule to it.

A shareholder's relatively small opportunity to exercise voice amounts to her ability to vote for directors and on any proposals for which a shareholder vote is required under the corporation's governing documents. The vast majority of corporate decisions, however, are made by the directors and managers without any consultation of the shareholders. Even when a shareholder can vote—say, to elect the directors or to amend bylaws—the weight of her vote is tied to the size of her investment because votes are usually allocated by share, not by person. For an individual to match the voice of a large institutional shareholder or a particularly wealthy individual, she will often have to join together with thousands of other individuals.<sup>82</sup> Doing so is obviously costly, and requires finding those other shareholders, contacting them, convincing them to agree with you, and convincing them to vote. These collective action problems are often insurmountable. Not only are these costs high; the availability of exit as an alternate option makes incurring them largely irrational. A shareholder's rational ignorance about most issues and attention only to the bottom line therefore means that voice, even if more available, would rarely be employed.<sup>83</sup> Again, though, it is precisely because of the exit option that this is true, and the existence of that exit option provides a powerful mechanism to police the board even in the absence of much voice.

By contrast, it would seem that the difficulty with exit functioning effectively as a means of accountability in the HOA is balanced by a more salient ability to exercise voice. After all, the community is smaller and more immediate, so it is easier to talk to the other voters.<sup>84</sup> Moreover, votes are allocated by home, so there is less disparity in voting power and often no single majority voter. However, this promise

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82. Cf. *Terry v. Adams*, 345 U.S. 461, 493 (1953) (Minton, J., dissenting) (“Often a small minority of stockholders control a corporation. Indeed, it is almost an axiom of corporate management that a small, cohesive group may control, especially in the larger corporations where the holdings are widely diffused.”).

83. See, e.g., James P. Holdcroft, Jr. & Jonathan R. Macey, *Corporate Governance: Flexibility in Determining the Role of the Board of Directors in the Age of Information*, 19 *CARDZO L. REV.* 291, 301–02 (1997) (noting that “the collective action problems of free riding and rational ignorance often create conditions in which it is not within shareholders’ interests . . . to become informed about the merits of a particular transaction” and that “even when shareholders know what is best for their firms, collective action problems may create conditions under which shareholder voting to further their own private objectives results in an election outcome that makes the shareholders as a group worse off”).

84. See Alexander, *supra* note 79, at 152–53 (discussing how it may appear that HOAs provide a good deal of voice).

of voice is unmet in the reality of HOA living. Nearly every scholar to study HOAs is of the strong opinion that there is a profound “failure of voice in this setting[.]”<sup>85</sup> that “the vision of self-governance and participatory democracy within these groups often is illusory,” and that homeowners are “at best uninvolved” and at worst “frustrated and disillusioned” by boards that “make little effort to involve residents” and so alienate them from whatever formal process is theoretically available to them.<sup>86</sup> As a result, “these private governments are illiberal and undemocratic,”<sup>87</sup> “oligarchic,”<sup>88</sup> and characterized by “eighth-grade Mickey Mouse politics”<sup>89</sup> on the board and “apathy”<sup>90</sup> in the community. This is no theoretical discussion or hyperbolic assertion; empirical surveys performed by these scholars have repeatedly found that even frustrated and “acutely angry” residents still choose to be passive in spite of living in what may appear to be a formally democratic community.<sup>91</sup>

Part of the blame for this apathy rests, of course, with the residents themselves. While they often have the formal opportunity to speak at many meetings, and while they could certainly run for office if they wanted to, they tend to *choose* not to. And overwhelmingly so; in 23% of HOAs in one study, there were fewer candidates than there were seats on the board.<sup>92</sup> It may be hard, then, to have much sympathy for HOA residents, or to suggest that courts engage in a more thorough review of their situation, if they bring it on themselves.

But homeowner apathy is not just the product of laziness. Rather, like the rational ignorance of corporate shareholders, it is a reasonable and perhaps inherent consequence of HOA structure and processes. Without a salient, easily accessible means of monitoring and policing board conduct—in other words, without the stock price and exit available to corporate shareholders—homeowners require collective action, both in terms of monitoring and in complaining, to have any impact in terms of influencing an incumbent board. And because, as discussed below, homeowners have divergent and idiosyncratic interests,<sup>93</sup> the ability of a homeowner to harness the power of the community—a community with remarkably low turnout in board

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85. *Id.* at 148.

86. Alexander, *supra* note 33, at 43.

87. MCKENZIE, *supra* note 2, at 21.

88. *Id.* at 135.

89. Alexander, *supra* note 79, at 158.

90. Silverman & Barton, *supra* note 9, at 139.

91. Alexander, *supra* note 79, at 148.

92. Silverman & Barton, *supra* note 9, at 139.

93. See *infra* Part III(B)(5) (discussing heterogeneity of interests in HOAs).

elections to begin with<sup>94</sup>—is quite weak.<sup>95</sup> Finally, those residents who rent their units are *required* to be apathetic because they often have no vote at all. The “virtually standard restriction” that voting rights are held only by owners means both that renters have no voice and that owners who may own more than one home (and rent them out) have a disproportionately large voice.<sup>96</sup> Renters make up a significant population in many HOAs: as of about ten years ago, a median of 20% of California HOA units were rented, and in 14% of California HOAs, the *majority* of units were rented.<sup>97</sup> This profound disenfranchisement of renters, who are just as bound in their everyday lives by the rules of the HOA, clearly fails to appropriately distribute voice to those affected by the “structure of coercion and restraint” under which they live.<sup>98</sup> For the renter residents, their lack of voice is even more strongly embedded in the very structure of the community.

Residents’ difficulties with resorting to voice is also a product of the boards and board processes themselves. Indeed, the procedural rules set in many HOAs allow or encourage action by fiat by “fail[ing] to meet even a minimal level of due process,” not providing for notice of or opportunities to be heard, and requiring closed meetings even when considering imposing new rules and regulations.<sup>99</sup> It should therefore come as no surprise that the common stereotype, again reflected in empirical studies, is that, operating in such a system, those who sit on HOA boards tend towards the tyrannical, power-hungry end of the spectrum—the kind of people who “wanted to be fire chiefs when they grew up”—and tend to “treat the association as an extension of their own homes and exercise personal control over association affairs.”<sup>100</sup> The series of anecdotes recounted in the introduction illustrate this characterization well.<sup>101</sup> In fact, this assessment of HOA boards has become so ingrained in our societal consciousness that even sitcoms can rely on it for comic effect without appearing to be indulging something

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94. See MCKENZIE, *supra* note 2, at 147 (discussing low turnout).

95. See Gillette, *supra* note 23, at 1429 (discussing weak monitoring of HOA boards).

96. Alexander, *supra* note 33, at 45.

97. MCKENZIE, *supra* note 2, at 128 (citing Stephen E. Barton & Carol J. Silverman, *Private Government and the Public Interest Revisited*, in COMMON INTEREST COMMUNITIES, *supra* note 9, at 31, 35). Additionally, voting rights tend to be allocated by unit, not by individual. MCKENZIE, *supra* note 2, at 128.

98. Frank Michelman, *Universal Resident Suffrage: A Liberal Defense*, 130 U. PA. L. REV. 1581, 1587 (1982).

99. Armand Arabian, *Condos, Cats, and CC&Rs: Invasion of the Castle Common*, 23 PEPP. L. REV. 1, 22 (1995).

100. Silverman & Barton, *supra* note 9, at 139.

101. See *supra* notes 10–20 and accompanying text.

absurd.<sup>102</sup>

In addition to the ways that often closed processes damage opportunities for voice and encourage somewhat autocratic behavior, the fact that board membership is a volunteer activity<sup>103</sup> means that it tends to attract certain types of people: those interested in “maximiz[ing] personal interests,” or “busybod[ies]” who derive some sort of utility from supervising, monitoring, and controlling others that compensates for the lack of salary.<sup>104</sup> And the fact that boards tend to be somewhat small means that each individual member has a real ability to advance his or her own preferences.<sup>105</sup> Finally, by conveying or permitting the appearance that they are a small cabal<sup>106</sup> more interested in enforcing rules than in the collateral or even direct consequences of their actions for the targeted people,<sup>107</sup> the boards all but tell their constituents that they are not interested in hearing from them. In fact, according to one observer, boards actively disincentivize complaining by imposing “unpleasant and costly results for those who challenge them.”<sup>108</sup> One need not go as far as ascribing such vindictive motives to all boards,

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102. For example, the sitcom *Frasier* depicted HOA tyranny and unaccountability beautifully in the 1997 episode, “Three Days of the Condo.” Referring to the entrenched and resented president of the condominium board, Daphne Moon, the British nurse and housekeeper in Frasier’s employ, remarks upon the delivery of a reprimand from the board president, “Oh, that’s one of Ms. Langer’s no-no slips. I can’t stand that woman. Just because she’s president of the condo board she acts like this building’s her kingdom. Everything has to be done exactly the way she likes it.” When Frasier tries to argue his case before the board and is summarily dismissed, the following scene ensues:

Ms. Langer: Request denied!

Frasier: I appreciate your . . .

Ms. Langer: Are you still talking? Your request is denied! Sit down!

Frasier: But there has been no discussion; it hasn’t even been opened up to the floor.

Ms. Langer: I will entertain suggestions from the floor if anyone has any idea how to shut this man up!

Frasier: Forget it! I came down here expecting a fair hearing in the democratic tradition, but here you are: a tyrant more concerned with the exercise of power than with justice!

Well, I will leave now, taking solace in the certain knowledge that in time, you, Ms.

Langer, will join all tyrants on the ash heap of history!

*Frasier: Three Days of the Condo* (NBC television broadcast Jan. 21, 1997) (DVD on file with author).

103. MCKENZIE, *supra* note 2, at 183 (noting that directors are “untrained, unregulated, volunteer[s]”).

104. Gillette, *supra* note 23, at 1429; *see also* MCKENZIE, *supra* note 2, at 184 (“Others may serve because they enjoy wielding power over their neighbors.”); *id.* at 131–32 (discussing industry attitude in favor of harsh enforcement).

105. Gillette, *supra* note 23, at 1429.

106. *See* MCKENZIE, *supra* note 2, at 135 (discussing “common perception that boards are just a small group of powerful neighbors”).

107. *Id.* at 19 (“To many residents, association boards often seem to operate as though wearing blinders, rigidly enforcing technical rules against people’s use of their own homes and ignoring the consequences of such intrusive behavior.”).

108. Sharon L. Bush, *Beware the Associations: How Homeowners’ Associations Control You and Infringe Upon Your Inalienable Rights!!*, 30 W. ST. U. L. REV. 1, 7–8 (2003).

however, to recognize that the institution itself does tend to attract or encourage the “busybody” who, having tasted power, is permitted to exercise it as much as possible. Such overweening exercises of power by the board members, and the resulting feelings of futility and powerlessness in the community, thus create or deepen the profound apathy on the part of the residents and weaken the power of voice to serve as a mechanism of accountability.<sup>109</sup> It is a vicious circle: the residents’ structural apathy—whether because they are disenfranchised renters or just resource-conserving owners unable to overcome collective action problems—means that only the most power-hungry take the time to serve on the board, which only creates further apathy on the part of the residents, who feel even more powerless than before.

Finally, a significant part of the problem with both aspects of this vicious circle is the developers themselves. First, the developer sets all of the substantive and procedural rules at the outset when creating the declaration, and then locks them in by often requiring supermajorities or lender agreement to amend it.<sup>110</sup> In fact, developers may require supermajorities *of all owners*, not merely of those voting, to amend the declaration, thereby preying on the collective action and apathy problems discussed above to preserve their preferred vision of life in the community.<sup>111</sup> Moreover, in a community with mostly absentee owners and renter residents, it is entirely likely that many owners will simply fail to vote and thereby prevent change. In setting these conditions, the developer has, as one scholar colorfully puts it, “permitted [people] to live there forever according to his rules” in a scenario “closer to Genesis than Locke, resembling the early days of the Garden of Eden more than the Puritans’ arrival in the New World.”<sup>112</sup> In the beginning, the developer staffs the board with his employees,<sup>113</sup> and the developer often remains represented on the board long after the community gets off the ground as the owner of unsold units.<sup>114</sup> In some situations,

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109. See Frug, *supra* note 23, at 1070 (“[A] sense of powerlessness tends to produce apathy rather than participation.”); see *supra* note 67 (discussing how one’s effort to use voice is tied to perceived probability of success).

110. Alexander, *supra* note 33, at 44.

111. MCKENZIE, *supra* note 2, at 127 (“[T]he developer’s idea of how people should live is, to a large extent, cast in concrete.”); Barton & Silverman, *supra* note 97, at 35 (observing that rule changes typically take more than a majority and require a vote of owners, not residents); Arabian, *supra* note 99, at 19 (noting that, by virtue of drafting the declaration and requiring high thresholds to amend it, “[t]he developer . . . has tremendous, and disproportionate, impact on the eventual quality of lifestyle in the development, with owners concomitantly losing control over many everyday matters . . .”). Note also that the developer has different interests than do the homeowners, as highlighted in the discussion below about heterogeneity of interests, *infra* Part III(B)(5).

112. MCKENZIE, *supra* note 2, at 146.

113. *Id.* at 128.

114. Alexander, *supra* note 33, at 44.

developers have been known to retain as many as three votes for every one unsold unit, which means that “the developer is effectively in control of the association until nearly the entire project is sold.”<sup>115</sup> This involvement and control can last for years, or even indefinitely if the developer retains a number of units for rental purposes or represents investors who do so, which is not uncommon.<sup>116</sup> As a result, even if there were a concerted effort of the residents, or even of the resident owners, to exercise their voice, the developer’s power, embedded in the structure of the HOA, makes it largely an empty gesture.

Whatever the mechanism, the point is not *how* voice is made weak in the HOA but that it *is*, as a structural matter, a poor check on the board and therefore a truly weak source of accountability. Taking this broader view, Gregory Alexander argues that there is simply a general lack of “democratic culture” and “participatory consciousness” in HOAs.<sup>117</sup> As a result, the possibility for voice is not strong enough in the HOA to make up for its lack of exit option. Without it, the HOA fails on the two primary aspects of accountability.

### 3. Expertise

Because both exit and voice have failed, judicial deference to HOAs on the scale of the business judgment rule should be justified only if there is something in the structure or character of the institution that allays concerns of unaccountability, either by substituting for accountability or by suggesting that the unaccountability is tolerable. As discussed above, the primary substitute for accountability that administrative law and other areas of the law recognize is expertise. In this regard, both corporate boards and HOAs could be said to have some degree of expertise in their particular line of business or community, respectively. While in neither situation does that level of expertise amount to the kind of technical, scientific expertise that characterizes some administrative agencies, decisions made by a corporation are at least heavily advised, not just by consultants and lawyers, but by the officers who make the day-to-day decisions and who are often quite experienced and expert.<sup>118</sup> In this, corporate boards may develop a legitimate claim to expertise relative to that possessed by the courts. Moreover, directors are often more expert than the undifferentiated mass of shareholders; this is why shareholders give them their money and

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115. MCKENZIE, *supra* note 2, at 128.

116. Barton & Silverman, *supra* note 97, at 34–35.

117. Alexander, *supra* note 79, at 148, 163.

118. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) (discussing directors’ “business acumen, interest and expertise” as basis for reliance and deference).

trust them to aggregate it with other money and to use their superior business acumen to make smart decisions. Indeed, the Delaware General Corporation Law, the primary statutory framework within which many corporations operate, expressly recognizes that corporate boards operate with a respectable level of expertise by insulating directors who rely on expert advice in making choices or taking action.<sup>119</sup>

There is no such expertise or expert reliance in HOA boards. It is true that the board members “know” their community in an important way, but there is nothing that would keep a court from acquiring that same knowledge through thorough briefing and argument. For example, courts evaluate legislative zoning decisions all the time, and no one questions their competence or whether they possess the requisite understanding of the locality to do so.<sup>120</sup> Photos and testimony could certainly bring a court up to speed quite quickly on the particulars of the community in the ordinary course of presenting the facts of the case. Beyond that kind of knowledge, though, the HOA board has no advantage over the courts. Even Justice Armand Arabian, a former Associate Justice of the California Supreme Court and no stranger to hearing cases involving HOAs, land use, and property law on the bench,<sup>121</sup> recognized that, as a result of the apathy and voice issues discussed above and the general political structure of the HOA, “it is only fortuitous if members are [expert or] qualified to serve on the board of directors” and that HOA board members are “hit-or-miss [and] uncredentialed.”<sup>122</sup> It is thus hard to insist that the HOA board possesses some important degree of expertise that differentiates them from judges or from the other residents—the population from which they came, after

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119. DEL. CODE ANN. tit. 8, § 141(e) (2012) (“A member of the board of directors . . . shall . . . be fully protected in relying in good faith upon . . . such information, opinions, reports or statements presented to the corporation by any of the corporation’s officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person’s professional or expert competence . . .”).

120. See, e.g., *Vill. of Willowbrook v. Olech*, 528 U.S. 562 (2000) (permitting equal protection challenge to zoning ordinance to survive motion to dismiss); *Twigg v. Cnty. of Will*, 627 N.E.2d 742 (Ill. App. Ct. 1994) (finding zoning ordinance to be substantive due process violation as applied to specific parcel); *Cormier v. Cnty. of San Luis Obispo*, 207 Cal. Rptr. 880 (Ct. App. 1984) (evaluating and rejecting on merits, not for inability to evaluate, substantive due process challenge to zoning ordinance).

121. For example, Justice Arabian dissented in the *Nahrstedt* case discussed above, see *supra* note 25 and accompanying text (discussing use of reasonableness test); *supra* notes 53–57 and accompanying text (discussing *Nahrstedt*), seeking a stronger level of judicial review because the HOA’s authority was “unrestrained by basic principles of due process or even rationality” and “threaten[ed] fundamental interests heretofore assumed as sacrosanct incidents of home ownership.” Arabian, *supra* note 99, at 2. Justice Arabian also authored the California Supreme Court’s opinion in *Ehrlich*, a major exactions case. See *Ehrlich v. City of Culver City*, 911 P.2d 429 (Cal. 1996).

122. Arabian, *supra* note 99, at 21–22.

all.

Perhaps if HOA boards were as advised as corporate boards, though, their claim to expertise would be stronger. However, the degree to which such advice is sought or rendered varies widely, and even when it is present, the advice is not technical and is usually skewed in favor of the developer's interests. After all, it is the developer and the lawyers first selected by the developer who are often giving the advice, and they would be expected to simply advise the HOA to use good judgment and to "strictly enforce the developer's rules."<sup>123</sup> This is not the kind of advice that creates or transfers any subject matter expertise, so it does not enhance the HOA's claim to legitimacy by virtue of expertise. In this way, the HOA fails to substitute for its lack of constituent accountability in the way that a corporation can. And, to the extent that the corporation is not so expert either, recall that the availability of exit makes that lack of expertise less relevant. It is the HOA that needs expertise to compensate for the lack of opportunities for exit and voice, and the HOA does not have it.

#### 4. Impact Range

Once the means of and substitutes for institutional accountability fail, it is hard to justify an expansive form of judicial deference. As discussed above, without accountability or expertise, the deference-justifying advantages that an institution can have over courts disappear. Of course, deference rules also help courts by optimizing limited judicial resources, so perhaps one could accept deference as a judicial economy shortcut, even when the institution in question is unaccountable and inexperienced, if the questions posed by the institution are of little moment. While the business judgment rule's use in the context of corporations is sufficiently justified by accountability and some expertise, it is worth noting the scope of its impact for comparison purposes. Put simply, the impact of a corporation's decisions vis-à-vis the shareholders is limited to the value of the shareholder's holdings in the corporation. If the board makes a decision that bankrupts the company, the worst that can happen to a shareholder is that her investment will lose all its value. This is certainly a significant impact, but it is one that can be ameliorated through diversification, investment in mutual funds or index funds, and most of all, ease of exit. A stockholder can even leave a standing stop loss order to automatically trigger exit if the price drops below a certain number, so constant monitoring is not even necessary. Indeed, exit is both a mechanism of

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123. MCKENZIE, *supra* note 2, at 185 (discussing professionals advising HOA boards).

accountability and an exposure-limiting feature in the corporate context. Moreover, that risk is one that every investor wholly understands when he invests. Put another way, every investor knows that “the only promise that makes sense” in the corporate context is for the directors and officers “to work hard and honestly.”<sup>124</sup> This narrow set of presumed rights or claims on the board fits neatly with the narrow range of impacts that the corporate board can have on the shareholder.

There is no such self-limiting feature in the HOA, and the ranges both of presumed rights and of possible impacts of adverse board decisions are significantly larger. Indeed, the simple fact that one’s *home* is at stake—even threatened by HOA foreclosure, as noted in the introduction<sup>125</sup>—means that one carries with him a far greater set of expectations and rights in that context. This is a central tenet of tort and criminal law,<sup>126</sup> criminal procedure,<sup>127</sup> substantive due process doctrine,<sup>128</sup> and other areas of the law, all of which treat the home as special. And rightly so. When people buy a home, they anticipate receiving the full “bundle of rights”<sup>129</sup> that property represents in our country and making their home their “castle,” as the saying goes, even if they happen to buy their home in a HOA.<sup>130</sup> In fact, most empirical work has revealed that the vast majority of HOA residents did not seek

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124. FRANK H. EASTERBROOK & DANIEL R. FISCHL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 91 (1991).

125. *See supra* notes 14–18 (discussing foreclosure of Clauers’ home for delinquency of dues payments).

126. *See, e.g.*, RESTATEMENT (SECOND) OF TORTS § 85 (1977) (providing defense to battery or wrongful death claims in defense of property and self in certain circumstances); MODEL PENAL CODE § 3.04(2)(b)(ii)(A) (1962) (creating exception to self-defense duty to retreat when in one’s own home).

127. *See, e.g.*, *Silverman v. United States*, 365 U.S. 505, 511 (1961) (“At the very core [of the Fourth Amendment] stands the right of a man to *retreat into his own home* and there be free from unreasonable governmental intrusion.”) (emphasis added); *see also* *Kyllo v. United States*, 533 U.S. 27, 34 (2001) (emphasizing importance of search target being one’s home, “the prototypical and hence most commonly litigated area of protected privacy”); *Boyd v. United States*, 116 U.S. 616, 630 (1886) (noting “the sanctity of a man’s home and the privacies of life”).

128. *See, e.g.*, *Lawrence v. Texas*, 539 U.S. 558, 562 (2003) (“Liberty protects the person from unwarranted government intrusions into a dwelling or other private places. In our tradition the State is not omnipresent in the home.”); *id.* at 567 (referring to home as “the most private of places”); *Griswold v. Connecticut*, 381 U.S. 479, 495 (1965) (referring to home as “a particularly important and sensitive area of privacy”).

129. Arabian, *supra* note 99, at 19–20; *see also* MCKENZIE, *supra* note 2, at 146 (“The concept of ‘rights’ is replaced with the idea of ‘restrictions’ as the guiding principle in the relationship of the individual to the community.”); Stephen E. Barton & Carol J. Silverman, *Public Life and Private Property in the Urban Community*, in *COMMON INTEREST COMMUNITIES*, *supra* note 9, at 301 (observing that, while “[p]roperty ownership involves bundles of rights and obligations that can be put together in many ways” and while “property rights are central to the social structure of modern societies,” HOAs persist in limiting those rights).

130. *See* MCKENZIE, *supra* note 2, at 25 (describing American culture as “link[ing] ownership of private property with freedom, individuality, and autonomy”).

out a HOA,<sup>131</sup> that “few prospective owners intelligently review the restrictions” before they close on their homes, and that, even if they do, they tend to “miscalculate their own future attitudes . . . perhaps inaccurately expecting that friendly relations with neighbors will avoid hostile disagreements . . . .”<sup>132</sup> Moreover, as discussed above, those rules often change, and the resident will remain bound by them even if he did not vote for them or, if he is a renter, even if he did not even have the *opportunity* to vote for them.<sup>133</sup>

Further, as the anecdotes discussed in the introduction illustrate, the board retains such wide enforcement discretion that enforcement may manifest in perhaps unexpected or arbitrary ways. As a result, even expectations about or agreement with rules in principle does not necessarily amount to expectations about their enforcement. For example, all residents may agree that blocking a main driveway is and should be against the rules, but would any of them—or any of us—have thought that a brief good-night kiss would violate such a rule?<sup>134</sup> Would anyone reasonably expect to be denied the right to fly the American flag on Flag Day?<sup>135</sup>

The profound reach of HOA regulations extends into even resident *behavior*, encompassing not only means of external upkeep like how and when to make repairs<sup>136</sup> and what kinds of plants can be put in the backyard,<sup>137</sup> but internal activity too: the type of curtains that are permitted in the windows,<sup>138</sup> the maintenance of a home business, and even the maximum lengths of stay for visitors—a reach that regulates “a wider range of behavior than any within the purview of any local government.”<sup>139</sup> The impact is so large that some observers have suggested that it makes more sense to think of the HOA, not as a rights-based regime, but as a restriction-based one in which rights cannot be said to be violated because residents never had them to begin with.<sup>140</sup>

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131. Silverman & Barton, *supra* note 9, at 137; *see also* Arabian, *supra* note 99, at 2 (arguing that HOA boards can “threaten[] fundamental interests heretofore assumed as sacrosanct incidents of home ownership”).

132. Winokur, *supra* note 81, at 99–101.

133. *See supra* Part III(B)(2) (discussing limitations on voice).

134. *See supra* note 12 (discussing incident).

135. *Id.* (discussing Flag Day incident).

136. Bush, *supra* note 108, at 1.

137. Silverman & Barton, *supra* note 9, at 134.

138. *Id.*

139. MCKENZIE, *supra* note 2, at 129.

140. *See, e.g., id.* at 148 (“Residents in [HOAs] commonly fail to understand the difference between a regime based formally on rights, such as American civil government, and the [HOA] regime, which is based on restrictions. This often leads to people becoming angry at board meetings and claiming that their ‘rights’ have been violated—rights that they wrongly believe they have in the [HOA to begin with].”).

California's Justice Arabian wrote that the HOA governing structure "deprives owners of a substantial measure of independence" in large part because "it controls so many details of daily life" and does so in an "inflexible" way.<sup>141</sup> Indeed, much of what the HOA may do "would be unconstitutional" if it were done by the state or local public government.<sup>142</sup> The notion that HOA residents eagerly sought out the HOA community and its restrictions and brought all of these impacts on themselves, is misplaced; the reality is that most residents often had no such desire.<sup>143</sup>

This striking distinction between the HOA and the corporation in terms of the degree of insinuation into a person's everyday life is deepened by two additional insights into the powers of the HOA. The first is that the HOA can force a resident to spend money by levying regular and special assessments and therefore impact residents' private finances as well.<sup>144</sup> Owners may have to hand over thousands of dollars even if they do not support the expenditure decision, even if they do not have the necessary income to afford it, and even if they would have otherwise taken on the repair or improvement in question with a different contractor or with their own labor if they did not live in a HOA that had made a contrary decision for them. Put simply, "the individual owner loses control over the decision on when to spend money and how much money to spend."<sup>145</sup> A corporation, by contrast, can never demand additional spending on the part of its shareholders. The second is that the HOA can prosecute, judge, and penalize residents, with the board acting as "accuser and trier of fact"<sup>146</sup> all at once with "no separation of powers between the people who make and enforce the laws and determine both guilt and punishment."<sup>147</sup> A corporation certainly has no such authority over its shareholders.

This discussion of the HOA's impact range is not meant to indict the HOA as a bad institutional form. Rather, it is meant to point out how broad that range is so as to suggest that the failures of exit, voice, and expertise *matter* in a way that courts should care about. If the worst that the unaccountable institution could do is decide who will bring what to the office holiday party, then it would be preposterous to expect courts to have anything to do with the institution, let alone to review it at all

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141. Arabian, *supra* note 99, at 23.

142. MCKENZIE, *supra* note 2, at 183.

143. Silverman & Barton, *supra* note 9, at 137.

144. Bush, *supra* note 108, at 14.

145. Silverman & Barton, *supra* note 9, at 134.

146. MCKENZIE, *supra* note 2, at 129 ("There are no policies that separate the roles of accuser and trier of fact or that call for the empaneling of an independent, impartial jury. In most states, failure to pay the fine authorizes the association to attach a lien interest [and to foreclose on the unit].").

147. Barton & Silverman, *supra* note 129, at 310.

rigorously. But the HOA reaches into a resident's finances, home, and personal life, and holds in its hands the resident's ability to continue living in that home and to lead that life. These are certainly interests and impacts that rise to a level appropriate for judicial attention in the absence of institutional accountability factors that would otherwise justify deference.

### 5. Homogeneity

Finally, we may be less concerned by an unaccountable, inexpert institution exerting wide-ranging influence over its constituents without a meaningful judicial check if we had faith that the interests of the governed were relatively homogenous, and that the institution faithfully represented those homogenous interests. If the interests are homogeneous, then the collective action problems that plague the lack of voice dissipate and we could trust in the unanimity of even an apathetic group inside the institution to provide such a check.<sup>148</sup> Put another way, it is when the constituency is divided or when there is a chance that a majority will dominate a minority that some external check is needed. In the context of the corporation, the interest of the shareholders is essentially unified around profit. While it is certainly true that some shareholders may have preferences surrounding other corporate activity, like labor practices or environmental stewardship, it is not unreasonable for courts to assume, as they do, that the central interest a corporate board is permitted to pursue is profit.<sup>149</sup> Again, because corporations are accountable through exit, all of these alternate justifications for deference are less important than they are for HOAs, but it is worth noting that the corporation possesses this characteristic as well.

The HOA, on the other hand, is not characterized by fully homogenous interests. Granted, all of the homeowners would like to see their property values protected or growing, and in this way, they are similar to shareholders. However, because of the unique community nature of the HOA, an important wrinkle arises: every homeowner will prefer to be the one who engages in idiosyncratic or rent-seeking behavior at the expense of the community. Each homeowner wants to look at well-manicured lawns from his windows but may not much care what his own lawn looks like from others' windows, or wants *his* addition to get built but doesn't want his view obscured by anyone

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148. See Gillette, *supra* note 23, at 1413 (“Homogeneity implies that, within the association, the sources of friction . . . [including] the definition of permissible activities . . . have already been resolved. The existence of homogeneity suggests that minority interests are less likely to arise . . .”).

149. See *supra* note 38 (discussing *Dodge v. Ford* and shareholder profit as only corporate goal).

else's. This is not necessarily for malicious reasons; just as people tend to think that everyone else is a bad driver, homeowners may legitimately believe that everyone else's additions are bad or noncompliant, but that their own is not and should be permitted. Expanding beyond individual action, this difference of opinion also suggests that homeowners will likely disagree about how best to maintain property values. And while this is no different than any other institution, the intensely personal nature of these disagreements in which there may be no "right" answer—one may adore garden gnomes and think that they make property more attractive to people like him, another may detest them and think that they lower property values—means that there may be no objective criteria on which to choose a course of action. As a result of this peculiar type of heterogeneity, it is more likely that minority interests will arise and that people will differ in the utility they derive from both following and violating various rules.<sup>150</sup> As discussed throughout this Article, this certainly does happen—every anecdote or source of disagreement is itself proof, in a sense, of this heterogeneity and of the fact that it often goes unaccounted for in the ordinary course of community politics because of the lack of voice.<sup>151</sup>

These key idiosyncrasies also impact the provision of common resources like pools, tennis courts, gardens, parking lots, and the like. Everyone may like these things in the abstract, "but the specific 'draws' made against [them] take a multitude of different forms" because residents use them differently and sometimes incompatibly<sup>152</sup>—walking dogs, playing football, and sitting contemplatively, for example, may be conflicting uses of limited park space. Moreover, the most significant common resource in a HOA, its ambiance, is the one on which there is the greatest number of variant uses because of how linked "ambiance" is to personal preferences and conceptions of a good lifestyle. People will naturally differ on this score, and the fact that they all live in a HOA cannot be counted on to ensure that they agree because entry is often involuntary. If everyone did as they wanted, though, that ambiance would likely deteriorate simply as a result of the disharmony.<sup>153</sup> Someone, or more likely, many people, will have to be told that their conception loses and another's wins—and that they have to acquiesce

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150. See Fennell, *supra* note 5, at 858 ("People within those communities may be heterogeneous with regard to the benefits they would derive from violating each of those many rules.")

151. See *supra* Part III(B)(2) (discussing voice), note 91 and accompanying text (noting widespread anger but lack of resort to voice).

152. Fennell, *supra* note 5, at 854.

153. See *id.* at 855 ("It might be efficient for each of these individuals to take their preferred 'draws' against the neighborhood atmosphere; yet if everyone were allowed to do all of these things at once, then neighborhood atmosphere might rapidly deteriorate, as people undertook draws that were costly on balance.")

and live differently. This is certainly a far cry from the shareholder context, and combined with the range of impact, it makes the lack of voice in the HOA all the more problematic.

Finally, heterogeneous interests exist not only among homeowners but between the homeowners and the developer. As discussed above, the developer often remains in control of, or at least represented on, the HOA board for years after residents begin to move in,<sup>154</sup> and during that entire time, the developer's goal is naturally to sell houses at high prices. As Justice Arabian put it:

To the extent multiple restrictions make units more salable to certain people, the developer has an incentive to include as many as the market will bear. At the same time, protection of individual interests has little economic value; hence, those who may desire a less restrictive living situation can expect little accommodation.<sup>155</sup>

Mediating these competing interests within the community and trying to preserve harmony among the homeowners is, at best, a secondary concern for the developer, and has bite only insofar as it will impact his ability to sell houses.

This pervasive heterogeneity of interests, combined with the fact that these interests are often directly tied to how a resident lives his or her daily life, as discussed above, means that the HOA board is not simply a machine with one clear goal. Instead, it must mediate competing and intensely personal differences. If it did this well, with high levels of resident participation and voice, then the HOA may be deserving of a high level of judicial deference. In fact, however, it does it quite poorly.

As this Subpart has shown across all five governance criteria, the HOA as an institution lacks what we ordinarily think of as critical internal checks and sources of accountability. Considering that it is trusted with acutely important and immediate responsibilities and that it is faced with a highly complex and fluid set of interests that it does a poor job of assimilating, the HOA's failure to be internally accountable calls into serious question the propriety of a rule of judicial deference that essentially leaves the HOA to its own devices. While such a rule is appropriate for the accountable, relatively simple (in terms of narrowness and homogeneity) corporate board, the specific institutional differences identified here between that sort of board and the HOA make the business judgment deference rule inappropriate for the latter context.

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154. See *supra* notes 114–116 and accompanying text.

155. Arabian, *supra* note 99, at 19.

*C. Implications of Deference for Incentives and Governance*

Not only is application of the business judgment rule to the HOA context rooted in an institutional analogy that is actually absent, but that mismatch has the potential to distort HOA incentives and to promote or permit inferior governance. This inferiority comes in two forms. The first is the thread that has run throughout the entirety of the above discussion of institutional characteristics. A deference rule is essentially a heuristic or a judicial shortcut in which the courts assume they have some comparative disadvantage, in terms of accountability or expertise, and so structure a default approach around some presumed simplifying principle. But as a result, an actor aware of the rule can use the rule as a shield from external inquiry. This is certainly possible in all institutions, including the corporation, but the existence of the other checks discussed above limits the ability of the institutional actor to behave badly in that case. In the absence of checks that justify a court's use of this particular deference rule, there is very little left to ensure that a HOA board governs most effectively. The courts must therefore be available to step in and provide this kind of assurance, and under the business judgment rule, they are not. While a plaintiff can attract a court's attention by showing bad faith or disloyalty on the part of a HOA board, the weight of the burden on the plaintiff to do so and the subjective nature of many HOA judgments mean that it may often be impossible.<sup>156</sup> If a HOA deems a proposed architectural adjustment unsightly, for example, that homeowner is without any means of challenging that determination because, absent evidence of actual animus towards him or some other bad faith, no further explanation is needed from the HOA board. There is thus a vast gray area in which HOA boards can abuse their discretion without any real fear of oversight or reversal.

The second form of inferiority stems from the *purpose* of the deference rule. The business judgment rule is a means of incentivizing innovation and risk-taking in the development of new products and business methods.<sup>157</sup> The market provides sufficient discipline against excessive risk-taking or repeated foolishness and filters out firms with

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156. See, e.g., McCullough, *supra* note 10 (discussing HOA rules that “forbid ‘offensive conduct,’ defined as ‘activity which in the judgment of the Board of Directors is noxious or offensive to other home lot owners’”) (emphasis added).

157. See *Gagliardi v. TriFoods Int’l, Inc.*, 683 A.2d 1049, 1052 (Del. Ch. 1996) (“The [business judgment] rule could rationally be no different . . . Shareholders don’t want (or shouldn’t rationally want) directors to be risk averse. Shareholders’ investment interests, across the full range of their diversifiable equity investments, will be maximized if corporate directors and managers honestly assess risk and reward and accept for the corporation the highest risk adjusted returns available that are above the firm’s cost of capital.”).

reckless leadership. The threat of liability for a miscalculation is thus superfluous, and potentially dangerous insofar as it could lead corporate leaders to be *too* cautious and cause society to lose out on the benefits of innovation. The business judgment rule is thus a means of removing that threat by insulating directors from liability in all but the most egregious circumstances of true bad faith.

HOAs, by contrast, yield none of the same innovation benefits to society, and their residents certainly do not have the same interest in risk-taking. Whereas shareholders accept a certain amount of gambling, and diversify their holdings to hedge against it, homeowners do not diversify their housing holdings and are consequently far more risk averse regarding their homes. There is nothing about the HOA that suggests any reason to protect board members or to give them room to experiment, yet it is easy to see that the application of the business judgment rule to the HOA gives board members that very benefit by largely precluding external review of their decisions. As a result, the most a board member has to lose is his seat—an unlikely occurrence given the apathy discussed above. Of course, this is not to say that board members should instead be made personally liable for the failures of their ideas, but the business judgment rule is often unnecessary to prevent that in the HOA context. Unlike in the corporate context, most legal challenges to HOA action are demands for injunctive relief rather than for damages.<sup>158</sup> There is often simply no threat of liability to speak of, so there is consequently no need for a deference rule designed to insulate the institutional actors from liability.

In this way, the business judgment rule provides an unnecessary level of protection to HOA boards while at the same time incentivizing both abuse of discretion and risk-taking in an appropriately risk-averse environment. The next and final Part of this Article starts from the premise that the analogy between firms and HOAs is both factually incorrect and normatively undesirable and begins to build a contextually closer analogy—to administrative agencies—from which a deference rule can be drawn that would also provide HOAs with a more desirable set of community-regarding incentives.

#### IV. TOWARD A SUPERIOR INSTITUTIONAL ANALOGY? HOAs AND ADMINISTRATIVE AGENCIES

While this is not the first effort to suggest the need for an alternate conception of HOA deference, most other offerings fail to capture the

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<sup>158</sup> In almost all of the HOA cases discussed in Part II, for example, the plaintiffs were seeking injunctive relief.

specific nature of the problem exposed in this Article, namely that HOA institutional processes do not merit the sort of substantive deference the business judgment rule affords.

Some have suggested conceiving of judicial review of HOAs in the same way that courts review contract disputes: essentially with *de novo* interpretation of the contract, informed perhaps by the parties' contemporaneous understandings of the terms. Richard Epstein, for example, has argued in a different context that "the problems of homeowners' associations are identical to those of all long term relational contracts . . . ."<sup>159</sup> Robert Ellickson has also suggested that the contract analogy makes the most sense because homeowners associations are "perfectly voluntary," which means that "[i]n most instances, familiar principles of contract law justify strict judicial enforcement of the provisions of private . . . constitution[s]" like those governing HOAs, because strict enforcement protects homeowners' "reliance interests."<sup>160</sup> Taken just at this level, this analogy does not solve the problem of judicial review of subsequent HOA *action*, since it is really only relevant to HOA interpretations of the governing documents. Framed as such, it is therefore not really a solution to the institutional and normative problems posed by business judgment rule deference to substantive HOA actions.<sup>161</sup>

And when it comes to subsequent HOA action, the contract analogy's silence on the matter would seem to imply that courts should engage in no real review; after all, the HOA's authority to act is created and delegated in the contract. Paula Franzese therefore describes Ellickson's approach as "judicial laissez-faire," which would seem an accurate description.<sup>162</sup> But from a homeowner's perspective, most of the important disputes are exactly of this type. In other words, they revolve around post-contractual developments and new rules that the homeowner did not accept, and could not have accepted, at the time she entered the community.<sup>163</sup> More to the point, even if homeowners were

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159. Richard A. Epstein, *Covenants and Constitutions*, 73 CORNELL L. REV. 906, 924 (1988).

160. Ellickson, *supra* note 6, at 1520, 1527.

161. Though the question of review of HOA interpretations of their governing documents—Ellickson and Epstein's focus—is a topic beyond the scope of this Article, it is worth briefly noting that, even in its proper interpretive context, the contract analogy does not quite capture the fact that the HOA is more than a contractual arrangement between homeowners and developers. It is a governmental arrangement in which residents clearly delegate some authority, both legislative and interpretive, to a HOA decisionmaker. A deference scheme which imposes near-total judicial oversight fails to recognize the independence of the HOA that is enshrined in the very document the court would be reviewing.

162. Franzese, *supra* note 9, at 688.

163. Gerald Frug, one of Ellickson's chief critics, points out that:

[W]hile the original constitution of a homeowners association might well be the work of a developer without the participation of a single person who becomes a resident of the community. . . . Ellickson treats homeowners associations as if they come into existence

perfectly represented in drafting the original declaration, they should not thereby be estopped from challenging all decisions made by governing actors acting under the authority of the declaration. After all, acceptance of the United States Constitution certainly does not preclude a citizen from seeking review of acts taken by governmental entities under authority granted by the Constitution. Further still is the troubling possibility that judicial neutrality provides cover for real oppression within the HOA. As Gregory Alexander has observed, “[t]here is no state neutrality when, in the name of freedom of contract, the legal system confers upon groups the power to coerce those who do not conform to their private preferences.”<sup>164</sup> Courts would not permit the coercion by government of even one individual by differential, irrational treatment,<sup>165</sup> so why should courts behave any differently simply because a private contract created the coercive entity? In such a circumstance, supposed judicial neutrality would only lead to a non-neutral outcome.<sup>166</sup> Finally, this laissez-faire approach is essentially what we already have under the business judgment rule, so it would not seem to improve upon the status quo.

In the same article in which he discusses the contract analogy, Robert Ellickson also suggests that HOAs could be viewed almost like local governments, the only difference being that membership in local government is “sometimes involuntary,” in contrast to his perfectly voluntary vision of the HOA.<sup>167</sup> As analogies go, this is an improvement over the contract analogy in a number of respects. First, it abandons the fiction of perfect voluntariness.<sup>168</sup> Second, it captures the HOA’s legislative functions and better reflects its iterative, institutional

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by the voluntary agreement of the original settlers and treats cities as if they are created only after the residents are already in place. Yet, this public/private distinction is hypothesis and nothing more.

Gerald E. Frug, *Cities and Homeowners Associations: A Reply*, 130 U. PA. L. REV. 1589, 1590 (1982); see also Franzese, *supra* note 9, at 670 (noting that “subsequently-promulgated board rules, regulations, and bylaws that, by definition, were not contained in the originating scheme, are not entitled to the same degree of judicial deference [as a contract]” because “there is less of a likelihood that members took with record notice of the given rule” and because “subsequent adoptions may not enjoy the sort of mandate that one would expect to find associated with originating restrictions”).

164. Alexander, *supra* note 33, at 38.

165. See, e.g., *Vill. of Willowbrook v. Olech*, 528 U.S. 562, 564 (2000) (finding that plaintiff states a claim “where the plaintiff alleges that she has been intentionally treated differently from others similarly situated and that there is no rational basis for the difference in treatment,” even if the plaintiff is a “class of one”).

166. See Frug, *supra* note 163, at 1595 (“Whether the amount of coercion these property owners exercise through state enforcement of contract and property rules is more oppressive than that exercised directly by state action depends on the definition of property and contract that the state enforces.”).

167. Ellickson, *supra* note 6, at 1520.

168. See MCKENZIE, *supra* note 2, at 21 (discussing fiction of voluntariness); Frug, *supra* note 163, at 1593 (criticizing Ellickson’s “oscillation between public and private imagery”).

nature, rather than the one-off contract. Third, it minimizes the risk of unchecked coercion by opening up the sort of rational basis scrutiny that courts impose on legislatures—a thin reed, to be sure, but better than nothing. In this way, it is a more searching level of deference than the status quo.

But it achieves that more searching level of deference with a misplaced analogy. From a structural and process perspective, HOAs are a far cry from local government. They are privately created entities with no grounding in a unified system of government. They exist and create rules because state governments permit them to exist and create rules, not because they are governments themselves.<sup>169</sup> They have no separation of powers: the HOA creates the laws, enforces the laws, adjudicates disputes (at the first instance, at least), and punishes the guilty.<sup>170</sup> This structure “leaves association boards vulnerable to both perceived and actual favoritism and abuse of powers.”<sup>171</sup> As the discussion of voice in Part III explained, study after study reflects that “while community governance may be democratic in form, it may be coercive in substance.”<sup>172</sup> Moreover, HOAs are not built around the notions of public service and common good with which we describe government, but rather the more simple goal of orderly management.<sup>173</sup> This difference in focus and priority manifests itself in a wholly different sort of institutional process and character, and it is these aspects of government as an institution that justify the judicial deference that government receives. But while HOAs may seem like junior-league representative governments, they are simply are not enough like representative governments—and not like them in the right ways—for courts to treat them in the same manner and with the same respect. After all, the reason that applying the business judgment rule to HOAs is inappropriate—the reason to even probe an alternate framework—is that HOAs are insufficiently accountable to deserve a deferential shortcut which assumes responsiveness. The same could be said for analogizing HOAs to governments.

On a deeper level, suggesting the imposition of the sort of rational

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169. James J. Scavo, *Dispute Resolution in a Community Association*, 17 URB. L. ANN. 295, 319 (1979).

170. Silverman & Barton, *supra* note 9, at 142. For more discussion of differences between the HOA and the local government, see *id.* at 141–42. These are not all set out here only because they are less relevant to the question of the judicial role. See also Arabian, *supra* note 99, at 22 (“The board of directors passes the rules, prosecutes the alleged violators, and adjudges ‘guilt.’ The individual can hardly rely on the HOA to evaluate its own rules and enforcement action in a neutral manner.”).

171. Silverman & Barton, *supra* note 9, at 142.

172. Franzese, *supra* note 9, at 689; see also MCKENZIE, *supra* note 2, at 21 (“In a variety of ways, these private governments are illiberal and undemocratic.”).

173. Silverman & Barton, *supra* note 9, at 142.

basis scrutiny applied to governments misperceives the problem with HOA decisionmaking. It is not that HOAs are making decisions that are necessarily bad or unreasonable or biased; it is that they are operating in an overly-insulated, unaccountable fashion very different from local government. This HOA process failure is also why Franzese's "multi-factored reasonableness test" similarly misses the problem. Courts employing Franzese's contribution to this question would ask whether the HOA "decision at issue is rationally related to the association's purposes or imposes burdens that are disproportionate to any benefits would best achieve that delicate balance between board prerogative, the collective good, and individual welfare."<sup>174</sup> This reads as a slightly juiced-up rational basis review, and so it shares the benefits that the legislative analogy has over the contract analogy. It also better tailors ordinary review of legislative action to the specific sorts of problems likely to arise in HOAs. But it is designed to offer a judicial check on "disproportionately burdensome regulations," as determined by as many as eight factors, all of which go to the specific *substance* of the regulation in question.<sup>175</sup> It therefore intrudes too heavily on a HOA's delegated prerogative to decide for itself what its purposes are and how best to achieve them, especially since the HOA would carry the burden of proving the reasonableness of its rules. It involves courts too deeply in second-guessing independent governing entities capable of, for example, determining whether the rule is appropriate in light of changed circumstances or how beneficial it is to the community as a whole—just two of Franzese's eight factors.<sup>176</sup> But more problematic than all of this is the fact that its focus on substance fails to capture that the problems of HOA governance are failures of process, not necessarily failures of outcomes.

Compared to all of these options, an analogy to administrative agencies comes closest to capturing the forces at play within the HOA. It can therefore guide courts to objective and processual levers of review, rather than subjective and substantive ones, that are easy to apply, conserve judicial resources, protect HOA autonomy, and still promote substantively good HOA decisionmaking.

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174. Franzese, *supra* note 9, at 669. California, Franzese points out, has imposed by statute a similar test. *Id.* at 690–91.

175. *Id.* at 695.

176. *Id.* Moreover, an eight-factor, substantive test imposes significant judicial costs in terms of the time, attention, and resources, and it gives courts little real direction (what is the threshold tradeoff between community benefit and individual burden, for example?), and could very well result in courts intruding even more into HOA decisionmaking or, perhaps even worse, rubber-stamping HOA decisions just to move their dockets along—a result representing no real improvement over the status quo.

### A. *The Closer Institutional Match*

Right away, there is a simple resonance between HOAs and administrative agencies: both are governance entities that affect parties' rights and obligations and yet are neither courts nor legislatures. The administrative law scholar Kenneth Culp Davis defined an administrative agency in his seminal treatise along these lines, as "a governmental authority, other than a court and other than a legislative body, which affects the rights of private parties through either adjudication or rule making."<sup>177</sup> The HOA would precisely fit this definition too. But just as the mere fact that a HOA may be incorporated is not a justification for applying corporate law principles, this similarity is not enough on its own to apply administrative law principles—though it does actually capture much more about the institutional characteristics than the facile corporate label does. In the following Subparts, this Article therefore applies the same institutional factors developed in Part III to administrative agencies.

#### 1. Exit, Impact, and Homogeneity

These three elements of the HOA find far greater resonance in the administrative agency analogy than they do in the corporate shareholder analogy. First, as Part III illustrated, regulated entities in HOAs—the homeowners—face fairly high barriers to exit, especially when compared to a shareholder's exit route.<sup>178</sup> Entities regulated by administrative agencies perhaps face an even more impossible barrier to exit in that the only way to escape the agency's oversight is to exit the industry entirely, or to at least escape the agency's jurisdiction. With a federal agency, this may mean ceasing to do business in the United States. The homeowner and the regulated business both will find that the threat of or use of exit to discipline the governing institution will not be credible because the costs of exit are so great. In that circumstance, exit is simply not a response one can expect to anything but the most extreme agency action, if that. Indeed, on this first metric of accountability, administrative agencies are perhaps as far as one could imagine from the publicly traded corporation. Whether HOAs are quite that far is less important than the fact that they are much closer to the agency than the corporation.

Second, HOAs exercise influence over an enormous range of aspects of a homeowner's life, just like a regulatory agency controls the very

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177. 1 KENNETH CULP DAVIS, *ADMINISTRATIVE LAW TREATISE* § 1:2 (2d ed. 1978); *see also* Scavo, *supra* note 169, at 319–20, n.47 (making same point).

178. *See supra* Part III(B)(1).

ability of a regulated entity to carry out its business. Administrative agencies can force an entity to change the way it does business for environmental, safety, labor, and other reasons, or fine or even shut down that business if it fails to comply.<sup>179</sup> Thousands of jobs may hang in the balance of every regulatory decision. While the same is obviously true for corporate decisions, it is not true *from the shareholder perspective*. As discussed above, to a shareholder, the worst that can happen as a result of a corporate decision is that an investment is devalued. To a homeowner or a regulated business, the results of an adverse decision by a HOA or an administrative agency could be significant changes to a way of life or to the profitability of a business and the employability of its workers.

Third, whereas shareholders all have the same interest, HOAs must balance competing interests. Administrative agencies must do the same: EPA navigates between industry and environmental groups; the NLRB and OSHA do so between management and labor; the SEC does so between banks, customers, and investors; agencies like the FCC or the Federal Energy Regulatory Commission do so between new entrants and established market leaders; and so on. Entities with strongly opposed interests battle for attention and priority in administrative agencies every day, much like neighbors do in the HOA context.

Voice and expertise are more complicated, but each of them still ultimately points to the wisdom of adopting a deference rule for HOAs similar to that of administrative agencies. To best explain why, they are tackled in reverse order.

## 2. Expertise

Part III discussed the lack of expertise of HOAs—or at least the hollowness of that expertise as compared to what a court could be made to understand. Administrative agencies, by contrast, have a significant amount of expertise in their fields.<sup>180</sup> In fact, recognition of agencies'

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179. *See, e.g.*, Occupational Safety and Health Act, 29 U.S.C. §§ 657, 658, 662, 666 (2011) (Secretary of Labor may “enter without delay and at reasonable times” any workplace, secure injunctions against dangerous workplace practices, and issue citations and fines of up to \$70,000 for each willful violation of OSHA regulations, and of up to \$7,000 for each other “serious” violation); Clean Air Act, 42 U.S.C. § 7401–7671q (2011) (EPA must set emissions standards requiring maximum achievable emissions reductions for every emitter and may secure injunctive relief, civil penalties, or even criminal penalties for certain violations).

180. The Federal Energy Regulatory Commission (FERC) regulates the transmission and price of oil and electricity throughout the nation’s energy markets and interconnecting electric grids. EPA employs complex formulas to determine the amount of emissions reductions which are achievable by enough emitters to make it an appropriate standard. The Federal Communications Commission (FCC) regulates the radio frequency system and allocates to broadcasters specific spaces within the frequency spectrum. Few judges—and few lawyers—could be expected to fully understand or explain the nuances

expertise has always been a significant element of the foundation for the current framework of judicial deference.<sup>181</sup> But right now, thanks to the business judgment rule, inexpert HOAs receive *more* deference than expert agencies do under the administrative law principles discussed below—this despite the fact that almost all the other bases for deference link HOAs closer to agencies than to publicly traded firms. That the disanalogy in expertise runs in this direction speaks to *less* deference for HOAs, not more. A world in which HOA decisions are essentially unreviewed but, say, EPA’s decision to set threshold *x* as opposed to threshold *y* for a given hazardous air pollutant receives judicial scrutiny—even very deferential scrutiny—is incoherent. That is, of course, unless HOAs are superior to agencies on the final element: voice.

### 3. Voice

Administrative agencies can provide opportunities for voice on two levels. The first is the broad, political level. Constituents and regulated entities unsatisfied with the actions of the agency can elect a new president who can install new leadership in those agencies. Presidents often campaign either on the need for fewer regulations—responding to a constituency that feels burdened by agencies—or on the need for more strict regulations of, for example, the environment or the financial industry—again, responding to a certain constituency. It would seem that the opportunity for this level of voice to discipline an agency is quite strong. But just as with the HOA, appearances are incomplete. A score of independent agencies exist over which electoral politics play no role, and even in agencies subject to political control, while the overall direction of an agency or a particularly newsworthy regulation may be influenced by electoral forces, the outcome of a given regulatory decision sits too far beyond the interest of a national electorate for that decision to be influenced by the electorate’s voice. As one scholar of administrative agencies has written:

[T]he vast majority of regulatory decision making flies beneath the general public’s radar and implicates established preferences of the electorate only at very high levels of abstraction. Not only are most voters unlikely to know or care about most administrative decisions, but they will routinely have difficulty accurately gauging responsibility for

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of these sorts of sophisticated policy matters.

181. See, e.g., *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 865–66 (1984); Lisa Schultz Bressman, *Chevron’s Mistake*, 58 DUKE L.J. 549, 556 (2009) (explaining that congress delegates to agencies the authority to “elaborate regulatory policy” because agencies are “more expert and politically accountable than courts”).

those decisions that subsequently prove unpopular.<sup>182</sup>

Similarly, the sheer number of issues that are at play in and that decide presidential elections makes it nearly impossible for a president or an agency to “hear” any message specific to a given agency’s action, or for the electorate to be sufficiently focused on that action to make its specific preference known.<sup>183</sup> Finally, the four-year electoral cycle means that it will be too late to effectively influence most administrative decisions or to discipline an agency for its decision.<sup>184</sup> For these reasons, traditional political discipline is ineffective in the administrative context.

For voice to be an effective influence or source of discipline at the decision level, we must instead rely on the fact that agencies are also required by the Administrative Procedure Act (APA) to provide regulated entities with opportunities to comment on proposed rules before they go into effect.<sup>185</sup> Indeed, it was largely the recognition that agencies were not effectively disciplined by ordinary political means that prompted the development of the APA.<sup>186</sup> The courts also generally require agencies to consider and respond to most of those comments in writing and in a public record, recognizing that “the opportunity to comment is meaningless unless the agency responds to significant points raised by the public.”<sup>187</sup> The problems of electoral voice discussed

182. Glen Staszewski, *Reason-Giving and Accountability*, 93 MINN. L. REV. 1253, 1271 (2009).

183. See Edward Rubin, *The Myth of Accountability and the Anti-Administrative Impulse*, 103 MICH. L. REV. 2073, 2079–80 (2005) (noting that “most electoral democracies present the voters with only two or three realistic choices, which means that a multitude of issues must map into a small decision set” and that voter preferences “tend to be stable, long-term preferences on leading issues, rather than detailed assessments of particular decisions”).

184. See Staszewski, *supra* note 182, at 1254 (“Public officials are not held politically accountable for their specific policy decisions pursuant to periodic elections, and there are overwhelming reasons to believe that this will never be the case. Moreover, in the absence of a reliable enforcement mechanism, modern public law’s efforts to legitimize government authority by connecting specific policy decisions to the will of the majority are bound to be misplaced.”); *id.* at 1266 (“For this form of political accountability to work, . . . it would be necessary for the electorate (1) to know about the government’s decision; (2) to have an established preference about its desirability; (3) to be capable of identifying who was responsible for the decision; and (4) to vote on the basis of this information at the next election. One need not be a rocket scientist—or even a political scientist—to realize that this set of conditions will only be satisfied in the most extraordinary of circumstances.”); Rubin, *supra* note 183, at 2079 (“[I]ntermittent, highly contested elections are simply very poor devices for holding a person accountable.”).

185. 5 U.S.C. § 553 (2011).

186. See WILLIAM N. ESKRIDGE, JR., PHILIP P. FRICKEY & ELIZABETH GARRETT, *CASES AND MATERIALS ON LEGISLATION, STATUTES, AND THE CREATION OF PUBLIC POLICY* 1121 n.e (4th ed. 2007) (discussing recommendations of 1938 ABA Special Committee on Administrative Law and of President Roosevelt’s Attorney General’s Committee on Administrative Procedure, both of which expressed concern that lawless agencies needed regularized procedures to protect regulated interests).

187. *Home Box Office, Inc. v. FCC*, 567 F.2d 9, 35–36 (D.C. Cir. 1977). The court went on to explain that “only comments which, if true, raise points relevant to the agency’s decision and which, if adopted, would require a change in an agency’s proposed rule cast doubt on the reasonableness of a

above are solved under the APA since only the most affected parties would go through the effort and expense of commenting. This efficiently ensures that agencies are not faced with nationwide grunts of reaction but rather detailed and explanatory reactions that can actually guide policy. And agencies comply with the APA's requirements because, if they don't, an entity can prevail against the agency in court, as is discussed further below. Indeed, it is the check placed by courts on an agency's ill-considered decisions that coerces better-considered decisions from the agency.

The HOA is most akin to an administrative agency in a world without the APA: a theoretically responsive, actually insulated policymaking entity with enormous impact and significant coercive power. This should not be taken to break the analogy between HOAs and administrative agencies, but rather to point toward the solution for HOA unresponsiveness. The HOA's missed opportunities for voice are not inherent in the HOA design, so if they could instead be harnessed, the HOA's decisional processes could provide residents with more voice.

These five factors were presented in Part III as elements of, and substitutes for, accountability. Because exit is foreclosed in both HOAs and agencies, accountability in both relies on voice. Because impact range and homogeneity are of similar magnitudes in HOAs and agencies, substitutes for accountability in both rely on expertise. The agency takes advantage of both its expertise and its opportunities for voice, but because expertise is *weak* in the HOA, voice is all that is left to discipline it. That it does not is a function of the absence of any institutional actor demanding it. Congress and the courts demand it for agencies with the APA. Without a statutory solution for HOAs, courts can and should draw on the institutional similarities of HOAs and agencies and begin to demand it in HOAs just like they do for agencies.

### *B. Administrative Deference Rules*

To better understand how courts could demand voice in HOAs, a brief discussion of how voice operates in agencies is in order. In contrast to the review that firms (and HOAs) receive from reviewing courts under the business judgment rule, administrative agencies receive a slightly, but critically, more searching level of review that demands they show "reasoned decisionmaking."<sup>188</sup> This review is rooted in the APA's statement that agency actions—both rulemakings and

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position taken by the agency" and therefore require a response. *Id.* at 35 n.58.

188. See, e.g., *Allentown Mack Sales & Serv. v. NLRB*, 522 U.S. 359, 375 (1998); *Portland Cement Ass'n v. EPA*, 665 F.3d 177, 187, 188 (D.C. Cir. 2011).

adjudications<sup>189</sup>—are to be “set aside” if they are “arbitrary, capricious, or otherwise not in accordance with law,”<sup>190</sup> but it has been amplified by the Court; indeed, as Kevin Stack has argued, “virtually every form of agency action” is accompanied by a judicial “demand for explicit reason-giving.”<sup>191</sup> As the Supreme Court explained in *Overton Park*, “[a]lthough this inquiry into the facts is to be searching and careful, the ultimate standard of review is a narrow one. The court is not empowered to substitute its judgment for that of the agency.”<sup>192</sup> Courts have since expanded on the content of their review, explaining that it is employed to ensure that the agency “adequately explained the facts and policy concerns it relied on”<sup>193</sup> and that those facts “have some basis in the record.”<sup>194</sup> The agency must “consider reasonably obvious alternative[s],”<sup>195</sup> “examine the relevant data and articulate a satisfactory explanation for its action including a ‘rational connection between facts found and the choice made[.]’”<sup>196</sup> and “explain its reasons for rejecting alternatives,” including those raised by commenters, “in sufficient detail to permit judicial review.”<sup>197</sup> In other words, while courts cannot interfere with substantive judgments made by administrative agencies—while courts must be, “in the last analysis, diffident and deferential” to such choices<sup>198</sup>—judicial review must nonetheless be just searching enough from a procedural perspective to enable a court to determine that the agency took a “hard look” at the “relevant issues”<sup>199</sup> and

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189. *Allentown Mack*, 522 U.S. at 374 (“[A]djudication is subject to the [same] requirement of reasoned decisionmaking [as rulemaking is].”).

190. 5 U.S.C. § 706(2)(A) (2011). This requirement that agency action not be arbitrary or capricious is, of course, in addition to the requirement discussed above that agencies provide for an opportunity to comment on proposed regulations. My focus here on reasoned decisionmaking more broadly views these requirements as two pieces serving the same goal.

191. Kevin M. Stack, *The Constitutional Foundations of Chenery*, 116 YALE L.J. 952, 962 (2007). Stack makes this point as he nicely draws support from the nondelegation doctrine for the rule from *SEC v. Chenery*, 332 U.S. 194 (1947), that agency action may only be upheld on the basis of the grounds actually invoked by the agency. He goes on to tie *Overton Park* and *State Farm*, discussed *infra*, to the same reason-giving principle at the core of *Chenery*.

192. *Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402, 416 (1971).

193. *Natural Res. Def. Council v. SEC*, 606 F.2d 1031, 1053 (D.C. Cir. 1979).

194. *Id.*

195. *Id.*

196. *Motor Vehicle Mfrs. Ass’n v. State Farm Mut. Ins. Co.*, 463 U.S. 29, 43 (1983) (quoting *Burlington Truck Lines, Inc. v. United States*, 371 U.S. 156, 168 (1962)); *see also* *Weyerhaeuser Co. v. Costle*, 590 F.2d 1011, 1026–27 (D.C. Cir. 1978) (“First, [we] insist upon an explanation of the facts and policy concerns relied on by the Agency in making its decision; second, [we] see if those facts have some basis in the record; and finally, [we] decide whether those facts and those legislative considerations by themselves could lead a reasonable person to make the judgment that the Agency has made.”).

197. *NRDC*, 606 F.2d at 1053.

198. *Id.* at 1049.

199. *Action for Children’s Television v. FCC*, 564 F.2d 458, 479 (D.C. Cir. 1977).

alternatives, including those raised by commenters, and “acted in a manner calculated to negate the dangers of arbitrariness and irrationality”<sup>200</sup> such that the facts could “lead a reasonable person to make the judgment that the Agency has made.”<sup>201</sup>

Since this is ultimately not all that demanding a standard, most agency action is left undisturbed, but examples of when courts do remand decisions back to agencies for further study will begin to illustrate what this type of review would mean for HOA decisions.<sup>202</sup> The Supreme Court’s decision in *State Farm* is one such instance. In that case, the Court held that the National Highway Transportation Safety Authority’s (NHTSA) rescission of a requirement that new cars be equipped with passive restraints (like automatic seatbelts or airbags) was not the product of reasoned decisionmaking because NHTSA failed to consider certain less radical alternatives.<sup>203</sup> Having never considered these alternatives, NHTSA had “no reasons at all” for rejecting them and was therefore unable to explain to the Court “why it exercised its discretion in a given manner,” namely to rescind the rule altogether.<sup>204</sup> The Court also held that NHTSA made a finding about the safety benefits of automatic seatbelts that was, in the words of the court of appeals, supported by “not one iota of evidence.”<sup>205</sup> Notably, the Court was not interested in “upset[ting] the agency’s view of the facts,” but was instead concerned by the “limitations of the record” and by the unexplained gaps in logic between those facts and the agency’s conclusions.<sup>206</sup> On remand, the agency would have to revisit that logic and either explain those gaps or adjust its conclusions, either way providing the “requisite reasoned analysis.”<sup>207</sup> *State Farm* thus neatly operationalizes the difference between judicial intervention in an agency’s considered judgments, which is impermissible, and judicial

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200. *WWHT, Inc. v. FCC*, 656 F.2d 807, 817 (D.C. Cir. 1981) (quotation omitted).

201. *Weyerhaeuser Co.*, 590 F.2d at 1027 (citing *Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402, 416 (1971)). Recall that this is very similar to what the trial court had demanded in the *Rywalt* HOA case discussed above, see *supra* note 40 and accompanying text, before the appellate court reversed and employed only business judgment rule deference.

202. See *Am. Wildlands v. Kempthorne*, 530 F.3d 991, 997 (D.C. Cir. 2008) (“This standard of review is a highly deferential one. It presumes agency action to be valid.” (quoting *Ethyl Corp. v. EPA*, 541 F.2d 1, 34 (D.C. Cir. 1976)).

203. *Motor Vehicle Mfrs. Ass’n v. State Farm Mut. Ins. Co.*, 463 U.S. 29, 46–49 (1983). NHTSA concluded that automatic seatbelts would often simply be detached by drivers, which would make them ineffective. But this “does not cast doubt on the need for a passive restraint standard or upon the efficacy of airbag technology,” the other main passive restraint option. *Id.* at 47. Simply requiring airbags, instead of rescinding the whole rule, was an “alternative” that “should have been addressed and [had] adequate reasons given for its abandonment.” *Id.* at 48.

204. *Id.* at 48–50.

205. *Id.* at 51.

206. *Id.* at 52–54.

207. *Id.* at 57.

review of the sufficiency of the agency's procedures and analyses, which is required.<sup>208</sup> A court must leave alone a considered judgment, but it must first determine for itself whether the judgment was, in fact, considered.

Because it hears so many petitions for review of administrative agency action, the Court of Appeals for the D.C. Circuit has provided a significant body of law applying this review principle and illustrating its usage and effect. In *American Horse Protection Association*, for example, the court examined a Department of Agriculture regulation that prohibited elements of a practice called "soring," which involves fastening heavy chains on a show horse's front limbs to improve its performance. The Horse Association argued that intervening events had eroded the adequacy of the existing prohibitions and asked Agriculture to revise its rule. It was rebuffed with a simple statement from the Deputy Administrator that he had reviewed the most current studies and "believe[d] the most effective method . . . is to continue the current regulations."<sup>209</sup> The court held that this conclusory dismissal of the Association's concerns was "insufficient to assure a reviewing court that the agency's refusal to act was the product of reasoned decisionmaking" because there was "no articulation of 'the factual and policy bases for [the] decision.'"<sup>210</sup> Without imposing on the agency its view of the proper substantive outcome and even without forcing the agency to take any particular next step—the court expressly declined to *order* the agency to revise its rule<sup>211</sup>—the court ensured that whatever the agency did do next would be the product of reasoned decisionmaking by making it clear that a "reasonable explanation" would be a necessary predicate to upholding it.<sup>212</sup> This is precisely what arbitrary and capricious review is meant to accomplish.

The court's decision in *Weyerhaeuser* was similar. Faced there with an agency's rule, rather than its refusal to revise a rule, the court found that the agency's record "include[d] no mention of" two factors it "purportedly" considered and did not even discuss "their mode of being

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208. My use of the word "procedures" is not to suggest that the Court was dictating procedures to the agency in violation of *Vermont Yankee Nuclear Power Corp. v. Natural Res. Def. Council*, 435 U.S. 519 (1978). It merely refers to ensuring that the agency engaged in the "procedure" of reasoned decisionmaking. As the Court explained in *State Farm*, the requirement that an agency engage in reasoned decisionmaking is not the sort of "specific procedure" that it may not impose under *Vermont Yankee*. *State Farm*, 463 U.S. at 50–51. Instead, as discussed above, the requirement stems directly from the APA's command that decisions not be arbitrary and capricious and from the Court's interpretation of that statute. See *supra* note 190 and accompanying text.

209. *Am. Horse Prot. Ass'n v. Lyng*, 812 F.2d 1, 5 (D.C. Cir. 1987).

210. *Id.* at 6 (quoting *Prof'l Drivers Council v. Bureau of Motor Carrier Safety*, 706 F.2d 1216, 1221 (D.C. Cir. 1983)).

211. *Id.* at 7.

212. *Id.*

considered.”<sup>213</sup> The absence of justifications is a major blow to any agency action, perhaps exceeded only by an agency’s concession that its rule rested on “computations now admitted to be erroneous.”<sup>214</sup> Flawed and missing reasons for an action cannot rationally or logically support that action. So, concluding that the agency’s record lacked a “coherent discussion” of the factual basis and legislative goals underlying its decision, the court remanded the rule for further proceedings in which the agency would have to receive and respond on the record to comments from the regulated industry.<sup>215</sup> Just as in *American Horse*, though, the court was quick to note that it had no truck with the substance of the rule; rather, the agency simply failed to show that its conclusions were a “logical outgrowth” of the facts it had before it.<sup>216</sup> So long as the final rule, whatever its content, was logically premised on the facts, there would be no further need for judicial interference with the agency.

Finally, just recently, the D.C. Circuit sent an emissions regulation back to the EPA for reconsideration because EPA failed to account for an ongoing, parallel rulemaking process that would alter the relevant dataset on which those emissions standards had been calculated.<sup>217</sup> The court held that “[b]asing its decision on a premise the agency itself has already planned to disrupt is arbitrary and capricious,” that the agency had not taken a “hard look” at the problem created by the dataset changes, and that regulation was therefore not the product of reasoned decisionmaking.<sup>218</sup> Without inquiring into the wisdom of the regulation or even into whether the standard would become more or less relaxed once EPA reconsidered it, the court simply focused on the agency’s decisionmaking process and the commonsense conclusion that “when an agency is simultaneously in control of both defining the universe of relevant data and of applying that data to a given rulemaking, it cannot allow itself to do the latter without having already done the former.”<sup>219</sup>

These examples should flesh out what the requirement of reasoned decisionmaking entails and illustrate the difference between this standard of review and the review offered by the business judgment rule. Whereas the business judgment rule requires courts to defer even if the firm had no coherent reasons rooted in fact or ignored countervailing factual premises, the standard of review for administrative agencies

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213. *Weyerhaeuser Co. v. Costle*, 590 F.2d 1011, 1029 (D.C. Cir. 1978).

214. *Id.* at 1030.

215. *Id.*

216. *Id.* at 1031.

217. *Portland Cement Ass’n v. EPA*, 665 F.3d 177, 184–85 (D.C. Cir. 2011).

218. *Id.* at 187.

219. *Id.* at 188.

demands reasons, and courts are empowered to send action back for further reflection should an agency be unable to provide a logical justification for that action. Given the institutional disjunction between firms and HOAs and the similarities between agencies and HOAs, courts should consider applying the requirement of reasoned decisionmaking to HOAs in place of the business judgment rule. The next and final Subpart discusses why this would be a normatively desirable step.

### *C. Implications of Deference for Incentives and Governance*

Whereas the business judgment rule distorts incentives and promotes inferior governance, arbitrary and capricious review would align the HOA's incentives with those of its residents and would promote more careful and responsive governance. In short, this is not just an idea that has a certain institutional logic. It is an idea whose time has come.

First, and perhaps most simply, obligating HOAs to seek input and give reasons *ex ante* for their decisions in order to be able to successfully defend those decisions in court will ensure that HOAs think more carefully about those decisions. And "one of the best mechanisms" for improving decisionmaking "is forcing oneself to consider alternatives and carefully review arguments against one's position."<sup>220</sup> As the D.C. Circuit has said about administrative agencies, a reason-giving requirement coerces "reflective findings, in furtherance of evenhanded application of law, rather than impermissible whim, improper influence, or misplaced zeal."<sup>221</sup> In addition to reducing the impact of whim or influence, reason-giving reduces negative side effects of (presumed) expertise: the sense that everyone sees the world as you do and overconfidence in your decisions, for example.<sup>222</sup> And like any good deterrent, if reason-giving is built into the system and enforced with regularity and certain consequence, it will become habit.

Second, a requirement that HOAs give reasons and respond to alternatives and suggestions creates a dedicated forum for residents to make suggestions and raise concerns. Sometimes residents may know better than the board could about the specific circumstances they face, or how a given rule could impact them in particular in a way the board had not foreseen. This is not to say that every person must be accommodated, of course. The HOA is free to enact a policy that harms a given resident anyway, but at least everyone—the residents, the HOA,

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220. Rachlisnki & Farina, *supra* note 69, at 588.

221. Greater Boston Television Corp. v. FCC, 444 F.2d 841, 852 (D.C. Cir. 1970).

222. Mark Seidenfeld, *Cognitive Loafing, Social Conformity, and Judicial Review of Agency Rulemaking*, 87 CORNELL L. REV. 486, 496–99 (2002).

and any reviewing court—would take solace in the fact that the resident had been heard and that the HOA had determined that her complaint could be mitigated or that it was outweighed by the benefits that would accrue to the community at large.<sup>223</sup> Residents would benefit from the dignity of having been heard, and the community would benefit from having an organized forum in which concerns, objections, and perhaps even anger can be voiced with a constructive purpose. Such confidence in the HOA as a responsive and representative body could even begin to replace the appropriately cynical view currently in wide circulation and spill over into increased participation and increased compliance more broadly.<sup>224</sup>

Third, reason-giving serves as a substitute for shortcomings in representativeness. In the administrative context, scholars have long recognized that it “structures agencies’ interactions with citizens and with other legal and political institutions” and that it provides a compensating form of accountability which ensures that governance decisions are community-regarding rather than parochial.<sup>225</sup> This may be the argument made most often in the administrative context, and it is especially potent in the HOA context as well. For example, as the D.C. Circuit said in a 1970s case called *Greater Boston Telephone Corp.*:

Reasoned decision promotes results in the public interest by requiring the agency to focus on the values served by its decision, and hence releasing the clutch of unconscious preference and irrelevant prejudice. It furthers the broad public interest of enabling the public to repose confidence in the process as well as the judgments of its decision-makers.<sup>226</sup>

Administrative law scholars have come to the same conclusion as well. Glen Staszewski has written quite powerfully on the importance of reason-giving as “the enforcement mechanism that holds public officials accountable for making legitimate policy choices in a deliberative democracy.”<sup>227</sup> It limits the scope of discretion, ensures that “relatively selfish policy options [are] discarded in favor of more public-spirited alternatives,” and provides a powerful impetus for

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223. Cf. generally RICHARD L. REVESZ & MICHAEL A. LIVERMORE, *RETAKING RATIONALITY* (2008) (discussing importance of cost–benefit analysis in administrative decisionmaking).

224. See Drewe, *supra* note 29, at 343 (arguing that such an improved conception of the board could itself encourage more community-minded people to run for it and that cooperation increases when residents feel involved); Silverman & Barton, *supra* note 9, at 138 (making same point about increased cooperation).

225. Jodi L. Short, *The Political Turn in American Administrative Law: Power, Rationality, and Reasons*, 61 *DUKE L.J.* 1811, 1861–62 (2012).

226. *Greater Boston Television Corp.*, 444 F.2d at 852.

227. Staszewski, *supra* note 182, at 1283; see *id.* at 1282–84 (discussing how reason-giving promotes legitimacy).

consistency across similar situations.<sup>228</sup> Similarly, Jeffrey Rachlinski and Cynthia Farina have posited that selfishness, rent-seeking, and decisional biases are not necessarily the products of venality but are rather features of human cognition—our “shared fallibility”—and that these can be overcome or minimized by the sort of “public vetting and explanation” that comes with reason-giving.<sup>229</sup> As the stories discussed throughout this Article have illustrated, these are precisely the sorts of improvements HOA decisionmaking needs. Requiring this form of “deliberative accountability” from HOAs, just as is required from administrative agencies, could close the gap between a doctrine that assumes ordinary political accountability and a reality in which it simply does not exist.<sup>230</sup>

When the D.C. Circuit extolled the virtues of reasoned decisionmaking in *Greater Boston Telephone Corp.*, it observed with a certain charming quaintness the “day when a court upheld the sensible judgments of a board, say of tax assessors, on the ground that they express an intuition of experience which outruns analysis,” but welcomed the fact that the doctrine had since “evolved” to “insist[] on reasoned decision-making.”<sup>231</sup> It is high time the deference extended to HOAs evolves in the same way.

The primary objection to such a reason-giving requirement is that it may be costly and time-consuming. But this Article does not propose the sort of environmental impact statement or detailed forensic financial analysis the law at times requires of administrative agencies. Even subjected to the same standard of review as administrative agencies, the HOA would not require similar tomes of studies analyzing the outcomes simply because the issues addressed by HOAs are comparatively simpler than those tackled by agencies. Instead, a HOA must simply provide enough to prove to its residents and a reviewing court that it heard what people had to say, considered that input, and had a better reason for doing what it did instead. Imagine a community that has to hire an exterminator and there are three exterminators in town. Under the business judgment rule, the HOA can just pick one regardless of its

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228. *Id.* at 1280–81; see also Short, *supra* note 225, at 1861–62 (explaining how reason-giving “empowers agencies to do their jobs,” “constrains the kinds of actions that agencies deem possible and desirable to take,” and “constitutes agencies as organizations”).

229. Rachlinski & Farina, *supra* note 69, at 610–11.

230. Staszewski, *supra* note 182, at 1278, 1305–06 (discussing importance of hard-look review as judicial solution to political accountability problems). Staszewski argues that not only is deliberative accountability a “viable alternative,” *id.* at 1284, to electoral accountability, but a superior one, since it protects minority rights “regardless of the pre-political preferences of the majority,” *id.* at 1302. He may be right, but this discussion seeks only a substitute for a fundamentally lacking political accountability. If the substitution turns out to be even better than functioning electoral accountability, then all the better.

231. *Greater Boston Tele. Corp.*, 444 F.2d at 852.

cost, its track record, or any externalities it may impose (smelly or toxic chemicals, etc.). Under arbitrary and capricious review, by contrast, the HOA is still free to pick the expensive one, the least reliable one, or the externality-imposing one, but it must justify that decision to itself and its residents: it may be more expensive, but it's more reliable, the HOA may say. Or it may be less reliable, but it's cheaper; it may be noxious, but it's the cheapest and most reliable solution. Because judicial review under this standard is outcome-agnostic,<sup>232</sup> a reviewing court would have no trouble accepting any of these three outcomes as long as they came with one of these rationales and as long as that rationale was borne out in reality (i.e. the cheaper exterminator really was cheapest). One would hope a HOA board would already be considering these trade-offs, so the requirement of reasoned decisionmaking would not be too excessive a burden for a HOA board to bear.<sup>233</sup>

Of course, if the HOA is not already considering these sorts of questions, then this slightly-more-demanding level of deference would impose some new costs. But requiring a governing entity to give reasoned consideration to the issues it is charged with overseeing hardly seems unwarranted. "Reasoned decisionmaking," the D.C. Circuit recently said, "is not a dispensable part of the administrative machine that can be blithely discarded even in pursuit of a laudable regulatory goal."<sup>234</sup> Any costs of careful consideration faced by a HOA are far less compelling than those faced by administrative agencies. Moreover, as Mark Seidenfeld has noted in the agency context, concerns about the burdens that judicial review place on decisionmakers ignore the psychology of decisionmaking, which responds well to the sort of process-based review contemplated here for the reasons just laid out. So while some cost may be incurred, it buys "incentives for agency staff to take appropriate care and to avoid many systematic biases when formulating rules and ushering them through the rulemaking process" and "reduce[s] the probability of bias."<sup>235</sup> That certainly seems like money well spent.

Another objection is that HOAs may balk and ignore it, choosing to

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232. Mark Seidenfeld has argued that such indifference toward outcome, and focus on process only, is necessary for judicial review to effectively secure agency accountability. Seidenfeld, *supra* note 222, at 517.

233. As noted above, *supra* note 202, this standard of review is "highly deferential" and agency action—or, here, HOA action—is presumed to be valid.

234. *Portland Cement Ass'n v. EPA*, 665 F.3d 177, 188 (D.C. Cir. 2011); *see also Greyhound Corp. v. Interstate Commerce Comm'n*, 668 F.2d 1354, 1359 (D.C. Cir. 1981) ("The importance of reasoned decisionmaking in an agency action cannot be overemphasized. When an agency . . . is vested with discretion to impose restrictions on an entity's freedom to conduct its business, the agency must exercise that discretion in a well-reasoned, consistent, and evenhanded manner.").

235. Seidenfeld, *supra* note 222, at 547–48.

forego deference and bet that dissatisfied residents will not sue. This is certainly a possibility, but it is a possibility inherent in any system of consequence and punishment. Parties to contracts may breach, people who owe duties of care to others may be negligent, and drivers may exceed the speed limit, all hoping that they won't face the consequences, or perhaps calculating that their action is worth the risk. So be it. This possibility, even if it is a probability, has never stood in the way of creating a society of rules and laws.

One final objection is that it would be judicial overreaching to impose this deference rule on HOAs. After all, it was Congress which first set the bar on deference with respect to administrative agencies with the APA. A similar statutory solution would certainly be welcome in this context, but regardless, courts chose on their own to impose the business judgment rule on HOAs. Nothing keeps them from choosing this deference rule instead.

Adopting and adapting the standard of review from the administrative context will not ensure perfect action by HOAs. It has not done so for agencies, and so too it will not turn HOAs into paragons of democracy. But it would at least promote more thoughtfulness *ex ante* than the current deference rule does, and provide some basis for review, even if only procedural, *ex post* review.

## V. CONCLUSION

Courts ostensibly defer to the judgments made by governing institutions for a reason, but the current model of judicial deference to HOAs lacks a reason. Even most of the courts that apply that deference rule have failed to justify it. Nor could they, since the HOA and the publicly held firm are fundamentally different institutions when it comes to the values of representativeness and accountability which should inform a court's decision to defer. Drawing on the business judgment rule from the firm/shareholder context and its nearly unquestionable deference also distorts the incentives faced by HOA boards and contributes to their culture of tyranny. The current form of deference is thus both groundless and harmful.

Moving beyond the HOA context, the institutional analysis developed in this Article may be deployed as a useful metric for reexamining the deference regimes applicable to a number of forms of private governance. In evaluating the deference owed to those private governance institutions, courts and scholars should not hesitate to look across disciplines and to various forms of public government for new analogies, bearing in mind the existence and effectiveness of the institution's own accountability mechanisms—exit and voice—and the

institution's accountability substitutes—expertise, impact range, and homogeneity. When it comes to the HOA, the role of the courts in the administrative state is a good place to start. Though the institutions may seem at first blush to be quite different, they have quite a bit in common across the very same representativeness and accountability factors which distinguish firms from HOAs. Moreover, the administrative state's reason-giving requirement would better align the incentives of the HOA with those of the residents and could lead to substantively better, more well-considered decisions.

Adapting this slightly-more-demanding deference rule from the agency context to the HOA context would thus seem a logical and beneficial step, and one that illustrates the possibilities inherent in exploring interdisciplinary approaches to the construction of judicial deference regimes more broadly. Evaluating an institution's representativeness and accountability from the bottom up, and then comparing the judicial treatment of similar governance mechanisms, could open up space for innovative, more context-appropriate linkages to be made.

