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Finding Individual Tort Liability for Board Members

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Recently, the Appellate Division First Department, in *Fletcher v. Dakota, Inc.,*1 held that the business judgment rule does not protect individual condo and co-op board members from personal tort liability where a board acting in its corporate capacity has acted in bad faith, but where it is not alleged that defendant board members have committed a tort independent of the tort committed by the board itself. As the court explained, "although participation in a breach of contract will typically not give rise to individual director liability, the participation of an individual director in a corporation's tort is sufficient to give rise to individual liability." In so deciding, the First Department expressly overruled its prior decision in *Pelton v. 77 Park Ave. Condominium*,2 which had held to the contrary. The court said it wanted to "clear up an element of possible confusion in this area of law that may arise out of [the *Pelton* decision]."

In doing so, the First Department brought its interpretation of the business judgment rule, as applied to condo and co-op boards, into alignment with its rulings in cases involving business corporations. The court noted that "it has long been held by this Court that 'a corporate officer who participates in the commission of a tort may be held individually liable,…regardless of whether the corporate veil is pierced,"3 that "[i]n actions for fraud, corporate officers and

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directors may be held individually liable if they participated in or had knowledge of the fraud, even if they did not stand to gain personally,"4 and that "officers, directors and agents of a corporation are jointly and severally liable for torts committed on behalf of a corporation and the fact that they also acted on behalf of the corporation does not relieve them from personal liability."5

Interestingly, in *Stalker v. Stewart Tenants Corp.*,6 a decision rendered just three months before *Fletcher*, a separate First Department panel held that the plaintiffs' complaint stated causes of action for housing discrimination against the corporate defendant, but that the individual board members who had approved the discriminatory acts of the corporation were not themselves subject to personal liability. The *Stalker* court stated: "Although allegations of unequal treatment of shareholders may be sufficient to overcome the protection afforded directors under the business judgment rule [for purposes of "board" liability], individual directors may not be subject to liability absent allegations that they committed separate tortious acts." Interestingly, since this decision was from a completely different group of Appellate Division judges, this decision could have an affect on how much credence the *Fletcher* decision receives.

Impact of 'Fletcher'

If *Fletcher* fails to be spurned by the Court of Appeals and its progeny of cases protecting board members by applying the business judgment rule, the decision will necessarily impact condo and co-op board membership in three ways: first, it will have a chilling effect on the willingness of qualified persons to volunteer to sit on these boards without compensation; second, it will permit individual board members to be personally liable for torts committed in their official capacity even though they believe they acted in good faith within the limits of their board authority; and, as discussed below, board members will have to serve at risk of incurring the costs to defend themselves, from charges of unlawful discriminatory acts or other bad faith conduct, without the protection of insurance.

The plaintiff in *Fletcher,* an African-American resident shareholder of The Dakota co-op in Manhattan, had applied for board approval to purchase an apartment adjacent to one he owns for the purpose of combining the two apartments. The board refused to approve the purchase, and the plaintiff alleged that, in refusing its approval, The Dakota and two of its directors had discriminated against him on the basis of race. The defendant directors contended that the discrimina-

tion claims should be dismissed against them because the complaint failed to allege that they had engaged in any acts separate and distinct from actions they took as board members. In response, the court stated that "there is no principle of corporate law that director liability arises only where the director commits a tort independent of the tort committed by the corporation itself."

Although the *Fletcher* court intended to address the confusion it perceived in condo/co-op law, the decision raises new questions concerning the scope of board insurance coverage. Will carriers provide insurance protection to individual board members accused of wrongdoing when acting as "the board," and will condo and co-op apartment owners readily volunteer to sit on boards whereby they will not only have increased exposure to potential personal tort liability, but whereby they may also incur personal responsibility for the legal costs of defending "board" action they honestly believed was rendered honestly and in good faith?

Business Judgment Rule

Ever since the Court of Appeals decided *Matter of Levandusky v. One Fifth Avenue Apartment Corp.*,7 New York courts have liberally applied the business judgment rule, originally developed in the context of commercial enterprises, to decisions made by condo and co-op boards in governing the buildings they control. As Levandusky explained, the business judgment rule "prohibits judicial inquiry into actions of corporate directors 'taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes,'" and "[s]o long as the corporation's directors have not breached their fiduciary obligation to the corporation, 'the exercise of [their powers] for the common and general interests of the corporation may not be questioned, although the results show that what they did was unwise or inexpedient.'"

In adopting the business judgment rule as the standard for judicial review of the decisions of non-profit corporations, the Court of Appeals stated that "courts are ill equipped and infrequently called on to evaluate what are and must be essentially business judgments [and] by definition the responsibility for business judgments must rest with the corporate directors; their individual capabilities and experience peculiarly qualify them for the discharge of that responsibility."

Levandusky further explained that "[t]he business judgment rule protects the board's decisions and managerial authority from indiscriminate attack. *At the same time, it permits review of improper decisions, as when the challenger demonstrates that the board's action has no legitimate relationship to the welfare of the cooperative, deliberately singles out individuals for harmful treatment, is taken without notice or consideration of the relevant facts, or is beyond the scope of the board's authority*." (Emphasis added). Nevertheless, the Court of Appeals held that "[s]o 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, [and] unless a resident challenging the board's action is able to demonstrate a breach of this duty, judicial review is not available."

Therefore, in *40 West 67th St. v. Pullman*,8 the Court of Appeals further held that, in order to trigger judicial scrutiny of the actions of condo and co-op boards, "an aggrieved shareholder-tenant must make a showing that the board acted (1) outside the scope of its authority, (2) in a way that did not legitimately further the corporate purpose or (3) in bad faith."

As a result, New York courts have generally insulated condo and co-op board members from personal tort liability for torts committed by "board" action, unless a board member could be said to have acted outside his or her official capacity and committed a tort separate and independent of the tort for which he or she was responsible solely as a board member. Only then would piercing of the corporate veil be allowed.9 As the *Pelton* court had held:

In bringing an action against the individual members of a cooperative or condominium board based on allegations of discrimination or similar wrongdoing, *plaintiffs were required to plead with specificity independent tortious acts by each individual defendant in order to overcome the public policy that supports the business judgment rule.* (Emphasis added).

However, the *Fletcher* court concluded (a) that "the *Levandusky* rule will not protect a board member where he engages in discriminatory conduct," and (b) that "*Pelton* takes a rule that applies where a cooperative or condominium board is alleged to have breached a contractual obligation,10 and incorrectly applies it where a board allegedly engaged in the intentional tort of discrimination." In addition, the court stated that "*Pelton* failed to disentangle the principles of individual corporate director liability in the breach of contract context (understood to provide a shield against liability) from the principles applicable to tort cases (where there is no such shield)."

D&O Policies

Accordingly, for tortious "board" action done in their official capacity, condo and co-op board members now face potential liability and attorney fee obligations from which they personally were previously immune. Directors & Officers (D&O) policies issued to condo and co-op boards by insurance carriers typically exclude from coverage "the willful violation of any law, statute or rule, committed by you or with your knowledge or consent." This is in accord with New York public policy which precludes insuring a tortfeasor against liability for injury caused by an intentional

tort.11

Thus, D&O policies may not provide coverage for intentional torts, such as defamation (although negligent misrepresentation may be covered), or violations of statutory anti-discrimination laws in which intent is an element. "One who intentionally injures another may not be indemnified for any civil liability thus incurred. However, one whose intentional act causes an unintended injury may be so indemnified."12 It is clear, therefore, that if the intent of the wrongful act is to cause the resultant injury (such as the harm caused by the invidious discrimination alleged in *Fletcher*), it cannot be indemnified as a matter of public policy.

The newfound exposure to potential personal liability facing condo and co-op board members is somewhat ameliorated by the fact, as the Court of Appeals stated in *Fitzpatrick v. American Honda Motor Co.*, that "an insurer's duty to defend is broader than its duty to indemnify."13 The court explained that it "has repeatedly held that an insurer's duty to defend its insured arises whenever the allegations in a complaint state a cause of action that gives rise to the reasonable possibility of recovery under the policy." Consequently, the courts "have liberally construed an insurer's general duty to defend in order to ensure the adequate and timely investigation of a claim and defense of an insured, regardless of the insured's ultimate likelihood of success on the merits."14 Moreover, the insurer is required to provide a defense, not only when the covered loss appears to lie within the "four corners of the complaint," but also when the insurer has "actual knowledge of facts establishing a reasonable possibility of coverage."15

Although the individual board member defendant is now at risk for his or her "board" actions, the insurance issues are similar to those which prevailed before *Fletcher* respecting the decisions made by insurers to defend allegedly tortious "board" activity. Therefore, while board members cannot avoid the prospect of having to personally defend baseless law suits brought for actions they do in their official "board" capacity, they may still obtain the benefit of an insured defense with a reservation of rights by the carrier, so long as the complaint in the suit (and/or the insurer's actual knowledge of the facts underlying the suit) provides a reasonable possibility of coverage under the terms of the policy. However, although a board member may thus receive the benefit of a paid defense by an insurer, a board member found liable for the tort committed in his or her official board capacity will nevertheless be responsible for any monetary judgment rendered in the case.

Only time will tell the magnitude and long-ranging effect of the *Fletcher* decision, but every practitioner and board member must be aware of its existence.

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Endnotes:

1. __ AD3d__, 948 NYS2d 263 (1st Dept. 2012).
2. 38 AD3d 1, 825 NYS2d 28 (1st Dept. 2006); see also Brasseur v. Speranza, 21 AD3d 297, 800 NYS2d 669 (1st Dept. 2005),
3. Citing Peguero v. 601 Realty Corp., 58 AD3d 556, __ NYS2d ___ (1st Dept. 2009).
4. Citing Savannah T&T Co. v. Force One Express, Inc., 58 AD3d 409, __ NYS2d __ (1st Dept. 2009).
5. Citing Marine Midland Bank v. Russo Produce Co., 50 NY2d 31 (1980); see also Kleinerman v. 245 East 87 Tenants Corp., 74 AD3d 448, 903 NYSd 356 (1st Dept. 2010); Ackerman v. 305 East 40th Owners Corp., 1889 AD2d 665, 592 NYS2d 365 (1st Dept. 1993).
6. 93 AD3d 550, 940 NYS2d 600 (1st Dept. 2012) (Full disclosure: The authors' law firm represented the plaintiffs in Stalker. The action has since been settled.)
7. 75 NY2d 530 (1990).
8. 100 NY2d 147 (2003).
9. See, e.g., Peacock v. Herald Square Loft Corp., 67 AD3d 442, 889 NYS2d 22 (1st Dept. 2009); Meadow Lane Equities Corp. v. Hill, 63 AD3d 699, 880 NYS2d 338 (2d Dept. 2009); Hill v. Murphy, 63 AD3d 680, 881 NYs2d 133 (2d Dept. 2009); Konrad v. 136 East 64th Street Corporation, 246 AD2d 324, 667 NYS2d 354 (1st Dept. 1998); DeCastro v. Bhokari, 201 AD2d 382, 607 NYS2d 348 (1st Dept. 1994).
10. See Murtha v. Yonkers Child Care Association, Inc., 45 NY2d 913 (1978).
11. See Town of Massena v. Healthcare Underwriters Mutual Insurance Co., 98 NY2d 435 (2002).
12. Public Service. Mutual. Insurance. Co. v. Goldfarb, 53 N.Y.2d 392, 399 (1981).
13. 78 NY2d 61, 65-66 (1991); see also BP AC Corp. v. One Beacon Insurance Group, 8 NY3d 708 (2007); Fieldston Property Owners Assn. v. Hermitage Insurance Co., 16 NY3d 257 (2011).
14. General Motors Acceptance Corp. v. Nationwide Insurance Co., 4 NY3d 451, 456 (2005); see also Automobile Insurance Co. of Hartford v. Cook, 7 NY3d 131, 137 (2006).
15. Fitzpatrick v. American Honda Motor Co., supra, n. 13; see also Technicon Electronics Co. v. American Home Assurance Co. 74 NY2d 66, rearg. denied, 74 NY2d 893 (1989); Meyers & Sons Corp. v. Zurich American Insurance Group, 74 NY2d 298 (1989).