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# Applying the Business Judgment Rule

## Individual Tort Liability for Co-op & Condo Boards

By **Adam Leitman Bailey**

Recently, the Appellate Division First Department, in Fletcher v. Dakota, Inc., involving a shareholder in The Dakota, a historic luxury co-op on the Upper West Side, 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.

Following the Business Judgment Rule

The Business Judgment Rule, a court-created rule that pre-dates cooperative corporations themselves, is a common-law doctrine by which courts exercise restraint and defer to good faith decisions made by boards of directors in business settings. The origin of the Business Judgment Rule derives from Section 717 of the Business Corporation Law (BCL), which states that "a director shall perform his duties as a director… in good faith and with that degree of care which an ordinarily prudent person in a like position would use under similar circumstances."

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, 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," that "[i]n actions for fraud, corporate officers and 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," 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."

Equal Treatment of All

Interestingly, in Stalker v. Stewart Tenants Corp., 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 effect on how much credence the Fletcher decision receives.

If this decision 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.

Discriminatory Actions?

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 discrimination 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? Only time will tell.

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