State Legislators, Insurers, and Courts to Homeowner Associations:

We Will Not Insure Intentional Torts

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The cover of the October 30, 1975, *Daily News* coarsely summed up President Gerald Ford's announcement denying federal funds to a New York City teetering on bankruptcy: "FORD TO CITY: DROP DEAD." *Ford to City: Drop Dead—Vows He'll Veto Any Bail-Out*, N.Y. Daily News, Oct. 30, 1975, at A1, available at http://en.wikipedia.org/wiki/File:Ford_to_City.PNG. Ford never uttered those notorious words, but his decision was calculated to convey that very message: the nation's refusal to bail out a city whose purportedly reckless and excessive spending had created its own financial crisis.

Ford's stance was premised on what economists refer to as "moral hazard," which predicts that parties are more likely to engage in harmful behavior if they know they will be insured from the consequences. This "tough love" logic is also at play in the policy of most states to deny insurance coverage for intentional acts of tortfeasors.

The boards of many homeowner associations (HOAs)—which govern collectively managed housing developments, primarily condominiums, cooperatives, and individual houses on plots deeded subject to reciprocal covenants and restrictions—face these same issues in defending suits for actions they have undertaken on a strictly nonprofit basis. When it is alleged that a HOA board member has purposefully discriminated on the basis of race, for example, the member should not expect to be indemnified for any resultant damages and may not even be entitled to have the insurer defend the action in court. This refusal to insure intentional acts of HOA directors is understandable but could spawn unintended mischief.

Individual Liability for Board Members

Similar to board members of business enterprises, HOA boards must look out for the well-being of the entity, on pain of exposure to personal liability. Further, they may be liable for their entity's torts simply by virtue of their participation in voting on the underlying action.

Yet unlike business board members, who collect a salary for their services, HOA board members spend their spare time in board activities without receiving compensation. HOA boards are drawn principally from their memberships. Uninsurable liability for damages can thus deter voluntary involvement. As *Jaffe v. Huxley Architecture*, 246 Cal. Rptr. 432, 434 (Ct. App. 1988), described:

> The board members of a homeowners association are seldom professional managers, are very often uncompensated and most often are neighbors. Undoubtedly, the specter of personal liability would serve to greatly discourage active and meaningful participation by those most capable of shaping and directing homeowner activities.

Recognizing the risks of imposing limitless liability, the laws of many states contain exceptions to general corporate agency principals to encourage what *Kleinman v. High Point of Hartsdale I Condominium*, 438 N.Y.S.2d 47, 48 (Sup. Ct. 1979), called the "gratuitous quasi-public service" of residential board membership. Louisiana, for example, statutorily immunized an unsalaried HOA director from individual liability when his actions were "in good faith and within the scope of his official functions and duties" and his misconduct was not "willful or wanton." La. Rev. Stat. Ann. § 9:2792.7. Thus, a condo board's alleged mismanagement of a mold problem, for example, would not expose its members to liability. *Caracci v. Cobblestone Village Condominium Ass'n,* 927 So. 2d 542, 546 (La. Ct. App. 2006). Similarly, in California, "while a condominium association may be liable for its negligence, a greater degree of fault is necessary to hold unpaid individual condominium board members liable for their actions on behalf of condominium associations." *Ritter & Ritter Inc. Pension and Profit Plan v. Churchill Condominium Ass'n,* 82 Cal. Rptr. 3d 389, 401–02 (Ct. App. 2008). In other states, HOAs are encompassed under the general immunity provided for the discretionary decision-making of directors of not-for-profit corporations. See, e.g., 805 Ill. Comp. Stat. 105/108.70 (immunizing unpaid directors and officers of nonprofit corporations for "damages resulting from the exercise of judgment . . . in connection with the[ir] duties . . . unless the act or omission involved willful or wanton conduct"); Wash. Rev. Code Ann. § 4.24.264 ("a member of the board of directors or an officer of any nonprofit corporation is not individually liable for any discretionary decision or failure to make a discretionary decision within his or her official capacity as director or officer unless the decision or failure to decide constitutes gross negligence").

The Federal Volunteer Protection Act, 42 U.S.C.A. §§ 14501 et seq., similarly protects directors and officers of not-for-profits, as defined in the act, from allegations of simple negligence. It is not entirely clear, however, whether the act covers homeowner associations. Litigants in a California case argued that homeowners associations are not protected by the act because they are "not organized and conducted for public benefit or operated primarily for charitable purposes, and there is nothing in the Act or its legislative history to suggest it was intended to benefit homeowner associations." See *Kashani v. Rochman*, No. B226060, 2013 WL 635962 at * 7 (Cal. Ct. App. Feb. 21, 2013) (noting that the act defines "nonprofit organization" as a tax-exempt organization described in 26 U.S.C. § 501(c)(3) or "any not-for-profit organization which is organized and conducted for public benefit and operated primarily for charitable, civic, educational, religious, welfare, or health purposes and which does not practice any action which constitutes a hate crime"). Disposing of the case on other grounds, however, the court declined to rule on whether the act applies to HOAs.

Until recently, in New York the rule of *Pelton v. 77 Park Avenue Condominium,* 825 N.Y.S.2d 28 (App. Div. 2006), gave HOA directors further protections, insulating HOA members both from allegations of negligence and claims of discrimination or other intentional torts. To claim against individual members, plaintiffs were required to plead specific allegations of tortious conduct, independent of the underlying tort committed by the board. The *Pelton* rule, however, was overruled. In *Fletcher v. Dakota, Inc.*, 948 N.Y.S.2d 263 (App. Div. 2012), the plaintiff sued his co-op and two of its directors, alleging that the board discriminated against him on the basis of race in refusing to approve his purchase of an adjacent apartment. Declining to apply *Pelton,* the *Fletcher* court wrote: "[A]lthough 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." Id. at 266; see also *Fielder v. Sterling Park Homeowners Ass'n*, 914 F. Supp. 2d 1222 (W.D. Wash. 2012) (concluding that under Washington state law, judicial deference to the purported "business judgment" of HOA decision making will not relieve individual directors of liability for intentional discrimination).

Fletcher and decisions like it simply apply to HOAs the general corporate doctrine that directors and officers can be jointly and severally liable for a corporation's torts. Nonetheless, they have sent shockwaves through the real estate legal community, exposing HOA volunteers to liability for actions taken in good faith and within the board's authority, making it necessary to procure comprehensive director's and officer's (D&O) insurance.

Such policies, however, are cold comfort to protect against claims that the law holds to be uninsurable, such as intentional torts and racial discrimination. In these, directors could potentially be on the hook for a mere vote. Widespread understanding of such risks in the lay community could make staffing HOA boards increasingly difficult.

Intentional Acts

Although there is scant case law specifying when HOA board members can be insured against losses arising from their commission of an intentional tort (such as discrimination), general insurance law provides significant guidance on how courts might approach the issue.

The purpose of insurance is to minimize risks from unforeseen occurrences, regardless of whether the losses resulted because of the fault of the insured. Essentially, *all* policies insuring against misconduct deviate from tort law's policy of deterring harmful behavior, as an insured insulated from the harmful consequences of actions is not disincentivized against the forbidden behavior, the "moral hazard." Society tolerates this situation because shifting responsibility to an insurer allows risk spreading, reducing overall costs, and recognizing that a moment's inattention is not necessarily justification for a lifetime of suffering. Insurance also encourages individuals who engage in otherwise beneficial conduct that could expose them to liability to continue that laudable goal while ensuring adequate recovery for injured parties.

Although those policies allow for liability insurance for negligence, they do not cover intentional misconduct. There, the availability of insurance could *directly* incentivize misbehavior, especially if born of spite or hatred. Because purposeful or intentional misbehavior is not unplanned or "fortuitous," it is

thus beyond the scope of the purpose of insurance agreements—managing contingencies and risks, not certainties. As the Florida Supreme Court bluntly put it: "It is axiomatic in the insurance industry that one should not be able to insure against one's own intentional misconduct." *Ranger Ins. Co. v. Bal Harbour Club, Inc.*, 549 So. 2d 1005, 1007 (Fla. 1989).

The uninsurability of intentional conduct usually arises from language in the insurance policies themselves. Policies generally expressly exclude the insured's "violation [that is] knowing and willful" as well as "matters uninsurable under the law pursuant to which the policy is construed." See, e.g., Exemplar Policy issued by Zurich American Insurance.

Nonetheless, it can be hard to tell whether a specific act is sufficiently intentional to be excluded from the policy. The New Jersey Supreme Court wrote: "Absent exceptional circumstances that objectively establish the insured's intent to injure [for example, the reprehensibility of the act in question], we will look to the insured's subjective intent to determine intent to injure." *Voorhees v. Preferred Mut. Ins. Co.*, 607 A.2d 1255 (N.J. 1992). In *J.C. Penny Casualty Ins. Co. v. M.K.*, 804 P.2d 689 (Cal. 1991), the court ruled that child molestation is intentional, wrongful, and harmful as a matter of law, despite expert testimony that the insured intended no harm. In *Germantown Ins. Co. v. Martin*, 595 A.2d 1172 (Pa. Super. Ct. 1991), the court found that the perceived "irrationality" of the insured's actions had no bearing on an intentionality inquiry, writing, "[o]bviously, no rational person would go on a shooting spree, but this in no way lessens the intentional character of the conduct, if such intent is evidenced."

Thus, regardless of the contract, public policy may require that coverage be denied. The public interest in discouraging intentional torts is greater than that of maintaining freedom of contract.

Codified Uninsurability

Numerous states have codified this reasoning into statutory law. See, e.g., Cal. Ins. Code § 533 ("[a]n insurer is not liable for a loss caused by the willful act of the insured; but he is not exonerated by the negligence of the insured, or of the insured's agents or others"); Mass. Gen. Laws Ann. ch. 175, § 47 ("no company may insure any person against legal liability for causing injury . . . by his deliberate or intentional crime or wrongdoing, nor insure his employer or principal if such acts are committed under the direction of his employer or principal").

Coverage Excluded Under Common Law

In most states, however, the "public policy exclusion" is common law. In Florida, the state supreme court fashioned a two-part test to determine "whether a particular policy of civil liability insurance is opposed to public policy." *Ranger*, 549 So. 2d at 1007. Under *Ranger,* a court should engage in a "deterrence" inquiry—a determination of whether this particular misconduct would be encouraged because of the availability of insurance and determine whether the purpose of the initial imposition of liability is "to deter wrongdoers or compensate victims." Id. Thus, in *Ranger*, the court prohibited indemnifying losses stemming from intentional housing discrimination on the basis of religion, relying on what it viewed as "Florida's long-standing policy of opposing religious discrimination" (evidenced in the Florida Constitution, the Florida Human Rights Act, and Fair Housing Act), as well as the fact that the majority of discrimination defendants are "commercial enterprises" with "far greater resources than . .

. individuals" and therefore rendering such actions uninsurable would "result in relatively few instances where the injury would go uncompensated." Id. at 1009. Thus, the practical consequence of the *Ranger* rule is to deny coverage for intentional acts.

This policy prevails in many states across the country. See, e.g., *Town of Massena v. Healthcare Underwriters Mut. Ins. Co.*, 779 N.E.2d 167, 171 (N.Y. App. Div. 2002) (holding that "[a]s a matter of policy, conduct engaged in with the intent to cause injury is not covered by insurance"); *Ambassador Ins. Co. v. Montes*, 388 A.2d 603. 606 (N.J. 1978) (recognizing a "general principle" of denying coverage for intentional torts); *Vorhees v. Preferred Mut. Ins. Co.*, 607 A.2d 1255 (N.J. 1992) (announcing that the "public policy" of compensating victims with insurance proceeds cannot supersede the public policy against insurance agreements that "condone and encourage intentionally wrongful conduct"); *Germantown Ins. Co. v. Martin*, 595 A.2d 1172 (holding intentional acts uninsurable as a matter of public policy, regardless of any irrationally impulsive nature of the action); *Graham Resources, Inc. v. Lexington Ins. Co.*, 625 So. 2d 716, 721 (La. Ct. App. 1993) (finding "as a matter of public policy people should not be allowed to insure themselves against acts prohibited by law such as securities fraud"); *Gearing v. Nationwide Ins. Co.*, 665 N.E.2d 1115, 1118 (Ohio 1996) ("Ohio public policy generally prohibits obtaining insurance to cover damages caused by intentional torts"); *Delta Pride Catfish, Inc. v. Home Ins. Co.,* 697 So. 2d 400, 405 (Miss. 1997) (holding that an enterprise "cannot purchase insurance coverage for its intentional, illegal activities"); *Groshong v. Mutual of Enumclaw Ins. Co.*, 923 P.2d 1280, 1285 (Or. Ct. App. 1996) (stating that public policy prohibits insurance for intentional housing discrimination); *American & Foreign Ins. Co. v. Colonial Mortg. Col., Inc.,* 936 F.2d 1162, 1165 (11th Cir. 1991) (stating that "all contracts insuring against loss from intentional wrongs are void in Alabama as against public policy").

Some states' rules are less emphatic than that of the *Ranger* court. The Illinois Supreme Court expressly declined to embrace this public policy exclusion "[i]n the absence of clearly articulated arguments or authority," thereby upholding an insurance agreement covering claims of retaliatory discharge. *Dixon Distrib. Co. v. Hanover Ins. Co.*, 641 N.E.2d 395, 402 (Ill. 1994). Subsequently, however, two Illinois courts have emphasized that the insurance proceeds may not be paid to the insured wrongdoer himself. See *Illinois Farmers Ins. Co. v. Keyser,* 956 N.E.2d 575, 578 (Ill. App. Ct. 2011), appeal denied, 962 N.E.2d 482 (Ill. 2011); *Lincoln Logan Mut. Ins. Co. v. Fornshell*, 722 N.E.2d 239, 242 (Ill. 1999) ("indemnity against intentional misconduct may be tolerated where it provides benefits for the victim, but not where it compensates the wrongdoer").

Similarly, in Minnesota, several cases have left open the possibility of allowing intentional tort coverage. In *Independent School District No. 697 v. St. Paul Fire & Marine Ins. Co.*, 495 N.W.2d 863 (Minn. Ct. App. 1993), an appeals court refused to read into an insurance policy an intentional acts exclusion when the agreement provided coverage for wrongful acts, yet did not qualify this coverage by reference to negligent conduct. Citing the "competing public policies which favor freedom of contract," the court enforced the policy. The court also disputed that the availability of coverage would "stimulate" discrimination, citing approvingly a Sixth Circuit case observing that "common sense suggests that the prospect of escalating insurance costs and trauma of litigation, to say nothing of the risk of uninsurable punitive damages, would normally neutralize any stimulative tendency the insurance might have." Id. at 867 (quoting *School Dist. v. Continental Cas. Co.,* 912 F.2d 844, 848 (6th Cir. 1990). But see

St. Paul Fire & Marine Ins. Co. v. Briggs, 464 N.W.2d 535, 539 (Minn. Ct. App. 1990) (stating that "[i]t is a central concept of insurance that a single insured will not be allowed, through reckless or intentional acts, to control the risks covered by the policy").

Missouri also appears to have cases with conflicting outcomes. In *White v. Smith*, 440 S.W.2d 497 (Mo. Ct. App. 1969), a Missouri appellate court stated that "as a matter of public policy, a liability insurance contract does not afford coverage for damage intentionally inflicted by the insured." Accord *Keeler v. Farmers & Merchants Ins. Co.,* 724 S.W.2d 307, 309 (Mo. Ct. App. 1987). The Eighth Circuit, however, stated that the language in these two cases was merely dicta and held that, under Missouri law, public policy would not prohibit coverage for intentional acts when the policy expressly provided for it. *New Madrid County Reorganized Sch. Dist. No. 1 Enlarged v. Continental Cas. Co.*, 904 F.2d 1236, 1241–42 (8th Cir. 1990).

Intentional Discrimination Is Uninsurable

Civil rights law recognizes a difference between actions that merely have the unintended consequence of discriminating against certain protected classes of people and actions taken with that specific goal in mind. Under cases such as *Ranger*, public policy does not prohibit ensuring against unintentional discrimination, "clearly a legitimate business risk." Insuring against *intentional* discrimination, on the other hand, is deemed contrary to public policy in the vast majority of both state and federal courts. See, e.g., *Jefferson-Pilot Fire & Cas. Co. v. Sunbelt Beer Distributors, Inc.*, 839 F. Supp. 376, 380 (D.S.C. 1993); *Groshong v. Mutual of Enumclaw Ins. Co.*, 923 P.2d 1280, 1285 (Or. Ct. App. 1996). But, as shown in *Independent School District No.* 697, and *New Madrid,* there are some contrary rulings. Thus, insurers systematically exclude intentional acts from coverage.

State insurance departments take a similar view. A New York State Insurance Department Circular Letter recognized that the state generally prohibits coverage for intentional discrimination, but argued that covering unintentional discrimination (that is, disparate impact cases, as compared with disparate treatment cases) in fact *furthers* the public policy against discrimination. N.Y. State Ins. Dep't Circ. Ltr. No. 6, Insurance Coverage for Discrimination Claims Based upon Disparate Impact and Vicarious Liability (N.Y. St. Ins. Dep't 1994), www.dfs.ny.gov/insurance/circltr/1994/cl94_06.htm. Thus, in the employment context:

> [b]y bringing to employers' attention practices that can potentially result in unlawful discrimination, insurers' loss prevention programs and underwriting standards should discourage such practices. Any employer who does not diligently attempt to modify employment procedures accordingly may well be denied insurance coverage. When unlawful acts of discrimination occur nonetheless, coverage will help ensure just compensation for victims.

Similarly, an Ohio Attorney General Opinion Letter, 1945 Op. Ohio Att'y Gen. 295, 298, states that violations of Ohio's anti-discrimination statutes "would not only be a crime but would necessarily amount to an intentional wrong committed against the aggrieved party" and thus be uninsurable.

A Broader Duty to Defend

> Although HOA directors may be unable to procure intentional tort insurance coverage, the duty of insurers to defend actions is far broader than their duty to indemnify, obliging the insurance company to provide a vigorous and good faith defense to the insured, regardless of the likelihood the insurer will pay the judgment. For example, a New York court recently observed that the insurer's duty to defend
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> arises whenever the allegations in a complaint state a cause of action that gives rise to the reasonable possibility of recovery under the policy . . . . Moreover if "any of the claims against an insured arguably arise from covered events, the insurer is required to defend the entire action." . . . It is "immaterial that the complaint against the insured asserts additional claims which fall outside the policy's general coverage."

Fieldston Prop. Owners Ass'n v. Hermitage Ins. Co., Inc., 16 N.Y.3d 257, 264–65 (N.Y. 2011) (internal citations omitted). Accord *Isenhart v. General Cas. Co.*, 377 P.2d 26, 28 (Or. 1962) ("the obligation of the insurer to defend is to be determined by the allegations of the complaint filed against the insured"). In short, courts look only to the complaint to determine whether the insurer must provide a defense. Well-advised plaintiffs' attorneys therefore will invariably plead (if they can) whatever facts or claims necessary to bring the suit within coverage, pleading both intentional tort *and* negligence theories to bring the insurance company to the table to defend the action, to encourage a settlement agreeable to both parties, and to provide a fund alternative to the actual defendant from whom a plaintiff can draw compensation (even if the negligence theory is tenuous).

For example, in *Lime Tree Village Community Club Ass'n, Inc. v. State Farm General Ins. Co.*, 785 F. Supp. 962 (M.D. Fla. 1991), several homeowners sued their village's association, alleging that the association's recent amendment to its "covenants and restrictions" limiting the community to adults age 55 or over constituted racial and age-based intentional discrimination, in violation of the Fair Housing Amendments of 1988 and Florida state law. Reversing the district court, the Eleventh Circuit, 980 F.2d 1402 (11th 1993), observed that the complaints sufficiently alleged that the amendment constituted a breach of the underlying covenants and restrictions, as well as "slander of title" and "restraint of trade," all state claims in which plaintiff need not prove intent in order to prevail. Even if these common-law theories were "'merely' creative discrimination claims," and even if the insurer would ultimately be exempt from indemnifying the association, the Eleventh Circuit held that the insurer nonetheless had a duty to defend "until all covered claims have been removed from the complaints." Id. at 1406.

The California Supreme Court was less indulgent in *Minkler v. Safeco Ins. Co. of America*, 232 P.3d 612, 622 n.4 (Cal. 2010), warning that courts should be "wary of policy interpretations that encourage artful and sham tort pleading" in which a plaintiff will allege intentional tort claims in negligence terms in order to bring the suit within coverage.

Although ethical considerations forbid sham pleading, obviously plaintiffs seeking actual compensation likely prefer their adversaries being amply insured to obtaining a crippling but ultimately unenforceable judgment. Because the client owns the case, if the plaintiff is looking merely to make an example of the defendant without a goal of pecuniary compensation, plaintiff's counsel will have to behave and plead accordingly. But, if the plaintiff wants compensation, counsel should be using all possibilities of good faith pleading of insurable wrongs. Compensation is vastly more likely with the involvement of the insurer.

Possible Responses and Outstanding Problems

One could argue that fear of liability for intentional torts could be overblown, that an innocent director who will not discriminate has nothing to worry about. The U.S. Supreme Court famously wrote: "The way to stop discrimination on the basis of race is to stop discriminating on the basis of race." *Parents Involved in Cmty. Sch. v. Seattle Sch. Dist. No. 1*, 551 U.S. 701, 748 (2007).

But that is an overly simplistic answer to the problem of potential and *insurable* liability. Not all persons found to have unlawfully discriminated actually did. Although nondiscrimination *reduces* potential liability, it does not abolish it.

HOA boards are invariably confronted with extraordinarily sensitive and potentially volatile decisions, such as whether to accept or deny an application for membership or a special residential privilege. Therefore, there is always the risk that a good-faith decision by the board could prompt a spurned applicant to file an intentional discrimination lawsuit, one that could, notwithstanding the truth, prevail in court. Unavailability of insurance coverage for such suits, therefore, potentially puts HOA directors in a serious bind. At the same time, policy dictates that discrimination should not be rewarded.

Practically, most of those board members sued will receive a free lawyer to defend the merits of the case because plaintiff attorneys almost always sue for more than one claim and the other claims will be covered. But an award by a judge or jury for intentional conduct would not be awarded or insured and a few of such cases being made public could cause volunteer board members to quit their boards in mass.

Conclusion

In the vast majority of cases, HOA board membership is both voluntary and thankless. Making it perilous can discourage all but the most foolhardy from serving. It is therefore necessary that board counsel be aware of these perils and be creative in ways to protect the communities they represent so that a board has a reasonable chance to get the most talented members rather than the most naïve.