



COOPERATIVES AND CONDOMINIUMS

Expert Analysis

Protecting Board Members From Personal Liability

New York case law affords co-op and condominium board members, in their capacity as such, broad protection from personal liability, including the liberal application of the business judgment rule¹ and stringent requirements for the imposition of tort liability.² In addition, statutes can protect board members from liability. However, statutory protection is not automatic; it must be included as part of the co-op or condominium's governing documents. Similarly, insurance coverage can offer protection, but it must be purchased and its terms complied with.

This column discusses statutes, cases and insurance that protect board members from liability for their actions in the course of board service, updates previous articles dealing with board liability and insurance³ and analyzes recent legislation and case law. This column also makes recommendations to boards and managers as to how to avail themselves of statutes and insurance that can protect board members.

Indemnification

Business Corporation Law (BCL) §§721-723 permit co-ops, most of which are organized under the BCL, to indemnify board members or officers who, by reason of board service, are sued in a civil or criminal proceeding.⁴ The New York Condominium Act permits condominiums to do likewise.⁵

Board members and officers should be indemnified against judgments, fines, amounts paid in settlement and reasonable expenses,



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including attorney's fees, if they acted in good faith, for a purpose they reasonably believed to be in the co-op or condominium's best interests and, in criminal proceedings, had no reasonable cause to believe their conduct was unlawful. Indemnification provisions should also require the co-op or condominium to advance defense costs.

Indemnification provisions are typically found in

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by-laws, but may also be in a co-op's certificate of incorporation. If the provision is in the certificate, BCL §803 requires that amendments normally be authorized by both a majority of the board and shareholders.⁶ Further, under BCL §725(d), amending by-laws regarding indemnification of directors or officers requires written notice to shareholders specifying the action taken.⁷

Eliminating Personal Liability

BCL §402(b) permits co-ops to include in their certificates of incorporation a provision eliminating personal liability of directors to the co-op and its shareholders for damages for breach of a duty owed to them.⁸ Recent case law confirms

that courts will enforce such a provision. In *Glazer v. Grossman*,⁹ the Appellate Division, Second Department, unanimously affirmed summary dismissal of breach of fiduciary duty claims against directors for settling claims against the corporation's former consultants, holding that the directors were shielded from liability by the exculpation included in the corporation's certificate of incorporation.

Therefore, for co-ops, if a certificate of incorporation does not exculpate directors from personal liability, it can and should be amended to do so. For condominiums, the act permits bylaws to provide for such exculpation.¹⁰ If no exculpatory provision is included, the by-laws can be amended. However, this generally requires a two-thirds vote of unit owners, in interest, which may be difficult to accomplish.

Retention of Experts

BCL §717(a)(2) permits co-op board members to rely on the advice of professionals or persons whom they believe have expertise in the matter at issue in performing their corporate duties. Directors are free of personal liability for actions taken in reliance on such advice.¹¹ The Court of Appeals in *Levandusky v. One Fifth Avenue Apartments Corp.*, expressly held that BCL §717 also applies to condominium boards.¹² Importantly, even if the advice relied on is ultimately determined to have been incorrect, exculpation from personal liability is unaffected.¹³

Agreements

Neither the BCL nor the act prohibits exculpation of board members and officers from liability for agreements made by the co-op or condominium. Where clear exculpatory language eliminating personal liability is included in such agreements, courts should dismiss contract claims asserted against board members or officers.¹⁴

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For example, in alteration agreements between apartment owners and co-ops or condominiums, eliminating personal liability of directors and officers should be enforceable. Courts consistently enforce provisions in such agreements exculpating co-op and condominium entities from liability.¹⁵ Therefore, there should be no judicial hesitancy to enforce provisions exculpating board members and officers.

Provisions by which apartment owners indemnify co-ops or condominiums and their board members and officers, including for legal fees, in connection with work that is the subject of the agreement are typically included in such agreements. However, statute and recent case law teach that careful drafting is required in order to render these provisions enforceable.

General Obligations Law §5-321 prohibits exculpation of liability by a lessor in agreements relating to operation of the building.¹⁶ While it is not clear from the statute that apartment alteration agreements are subject to its provisions, a 2010 decision by the Appellate Division, Second Department, held that enforceable indemnification provisions in leases and alteration agreements protecting the co-op (i.e., the lessor), must expressly exclude indemnification for lessor's negligence.¹⁷

Further, in *Gotham Partners, L.P. v. High Riv. Ltd. Partnership*, the Appellate Division, First Department, held that a broad indemnification provision in an agreement which includes legal fees must explicitly and clearly state its intention to cover an award of fees resulting from a claim between the parties, not only fee awards resulting from claims by third parties.¹⁸

D&O Insurance

Directors' and Officers' Liability Insurance (D&O insurance) is critical in protecting boards, their members and officers and co-op and condominium entities from liability for defense costs and damage or liability awards for claims related to board service.

Boards are typically composed of unpaid volunteers who are exposed to claims of mismanagement, misrepresentation, misuse of funds, improper allocation of resources, conflicts of interest, breach of fiduciary duty or wrongful termination. To encourage qualified people to serve on boards, co-ops and condominiums should purchase D&O insurance so that board members and officers do not put their personal assets at risk for a liability related to board service. While indemnification may accomplish the same goal, in the event of a lawsuit indemnification requires the co-op or condominium to fund payment of

defense costs or a judgment out of the entity's assets. The typical co-op or condominium may not have budgeted funds for this purpose and may therefore be required to either borrow money (which is difficult for condominiums) or assess apartment owners, including the board members or officers being sued.

Therefore, a prudent way to protect board members as well as the financial interests of all apartment owners is purchasing D&O insurance. Co-ops can purchase D&O insurance for the entity and its board members.¹⁹ Condominiums can purchase such insurance under their reserved powers to manage and operate the building.²⁰ Boards should also consider purchasing an umbrella policy to supplement D&O insurance. Litigation expenses and judgments can be costly, and layering, through the use of an umbrella policy, is a prudent economic way to enlarge coverage limits at a relatively low cost. It is also good practice to use an insurance broker

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knowledgeable as to the structure of co-ops and condominiums and how to efficiently maximize D&O insurance coverage.

D&O insurance should be as broad as possible and cover past, current and future board members, the board as an entity, persons who serve on board committees, and the entity itself. It is also common for property management agreements to require that managers be included as additional insureds on D&O insurance. Coverage should include litigation defense costs. Indeed, perhaps one of the most valuable components of D&O insurance is the duty-to-defend provision. If any claim made against the insured "arguably arise[s] from covered events," the carrier is "required to defend the entire action."²¹ Once the duty-to-defend is established, the carrier either assigns counsel or proffers a list to the insured to choose from.²² Choice of counsel is important because co-op and condominium claims raise distinct and unique issues. As such, it is imperative for assigned counsel to have a thorough knowledge of this area of law.

A carrier may defend a claim but reserve the right to disclaim liability by a "Reservation of Rights" or "Disclaimer" letter. However, where defense counsel's duty to the insured requires that liability be defeated on any ground and the duty to

the carrier requires that liability be defeated only upon grounds that would not render the carrier liable, a conflict of interest arises and the insured is entitled to independent counsel whose reasonable fees must be paid by the carrier.²³

Exclusions limit the protections of D&O insurance. A common exclusion is for claims based on property damage.²⁴ If the D&O carrier invokes such an exclusion, directors may still be indemnified by the entity, if the governing documents so provide. Other typical exclusions include libel, slander, invasion of privacy and environmental pollution. However, these claims may be covered by the entity's general liability insurance. Further, claims based on contracts with third parties are generally excluded, unless the insured would have been liable in the absence of a contract. Proprietary lease disputes and related breach of duty claims are generally covered by D&O insurance.

A sine qua non of D&O insurance is timely notification of a claim to the carrier. A typical policy requires notice when the "first notice of claim" occurs. However, the term "claim" is not clearly defined. One appellate court defined a claim as "an assertion of legally cognizable damage, which is capable of being defended and settled."²⁵ More recently, another appellate court held that a letter that did not demand payment nor advise that legal action was forthcoming did not constitute a notice of claim.²⁶

Notwithstanding these ambiguities, prompt notification to the carrier must be given. In *520 East 86th Street Inc. v. Firemen's Insurance Co. of Washington, D.C.*,²⁷ notification to the insurance agent who procured the policy, instead of to the carrier, was deemed an omission that, absent a reasonable excuse, discharged the carrier from its duty to defend and indemnify. In 2008, New York enacted legislation prohibiting carriers from denying coverage due to late notice, unless the delay "materially impairs" the insurer's ability to defend the claim.²⁸ However, this statute does not apply to claims-made policies. Because D&O insurance is generally written on a claims-made basis, this legislation will not benefit most co-ops and condominiums.

Therefore, strict compliance with notice provisions remains essential. When in doubt, it is prudent to submit notice of a potential claim to the carrier in order to preserve rights under the policy, even if the claim appears to be baseless or covered by another insurance policy.

New York law prohibits, as against public policy, insurance and indemnification from covering personal liability of board members for willful and intentional acts and punitive damage

awards.²⁹ In addition, neither indemnification nor D&O insurance can protect board members from personal liability for criminal acts, including criminal sanctions that are penalties for non-compliance with housing-related laws that apply to co-ops and condominiums.³⁰

Recommendations

While co-ops and condominiums cannot prevent board members and officers from being sued, they can take steps to maximize their protection from personal liability. Boards should review their articles of incorporation and by-laws. If they do not contain an exculpation from personal liability and broad indemnification to the fullest extent permitted by law for board members and officers, they should be amended to so provide in the manner required by applicable law. D&O insurance, broad in coverage and adequate in amount, should be purchased, premium payments timely made and notice of claim given to carriers at the earliest point possible. While neither statutes nor D&O insurance can fully protect board members from personal liability, they represent the best effort that co-ops and condominiums can make.

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1. See, e.g., *Levandusky v. One Fifth Avenue Apartments Corp.*, 75 N.Y.2d 530 (1990); *Peacock v. Herald Square Loft Corp.*, 67 A.D.3d 442 (1st Dept. 2009). The business judgment rule is also applicable to condominiums. See, e.g., *Pelton v. 77 Park Ave. Condominium*, 825 N.Y.S. 2d 28 (1st Dept. 2006); *Board of Managers of Fairways at North Hills Condominium v. Fairways at North Hills*, 193 A.D.2d 322 (2nd Dept. 1993); *Schoninger v. Yardarm Beach Homeowners Association, Inc.*, 134 A.D.2d 1 (2nd Dept. 1987).

2. In order to sue an individual board member, one must show that they committed independent tortious acts. See, *Murtha v. Yonkers Child Care Ass'n*, 45 N.Y.2d 913 (1978) (No cause of action will lie if an officer did not commit independent torts); *Konrad v. 136 East 6th Street Corp.*, 246 A.D.2d 324, 325-326 (1st Dept. 1998) (plaintiff/shareholder sought to amend her complaint to add a cause of action for breach of fiduciary duty against individual board members. The lower court granted leave to amend; the First Department reversed, stating "A review of the [proposed] allegations...reveals that the misconduct alleged was occasioned by the board of directors acting in its corporate capacity or by board members acting within the scope of their corporate duties...individual directors and officers may not be subject to liability absent the allegation that they committed separate tortious acts.")

3. See, R. Siegler, "The Liability of Board Members," N.Y.L.J. Jan. 7, 1998, pg. 3, col. 1; R. Siegler, "Directors and Officers Liability Insurance Issues," New York Law Journal, March 1, 2000, pg. 3, col. 1; R. Siegler, "Director, Officer Liability

Insurance," New York Law Journal, January 6, 1993, pg. 3, col. 1.

4. N.Y. Bus. Corp. Law §§721-723 (McKinney 2003 & 2010 Supp.). Amendments enacted in 1986 expanded the scope of then existing indemnification coverage for directors and officers.

5. N.Y. Real Property Law, Article 9-B, §§339-d to 339-kk (McKinney 2006 & 2010 Supp.).

6. N.Y. Bus. Corp. Law §803 (McKinney 2003 & 2010 Supp.). A certificate of incorporation may require more than a simple majority in order for it to be amendment. If so, the terms of the certificate govern.

7. N.Y. Bus. Corp. Law §725(d) (McKinney 2003). The statement must be mailed not later than the next annual meeting of shareholders, unless such meeting is held within three months from the date of such board action, in which case it must be mailed within 15 months from the date of such action.

8. N.Y. Bus. Corp. Law §402(b) (McKinney 2003). This provision was intended to encourage qualified persons to serve on boards without fear of exposure to personal liability. However, the statute expressly prohibits shielding directors from liability for acts or omissions made in bad faith, involving intentional misconduct, a knowing violation of law, for personal gain or in violation of BCL §719. See, BCL §402(b)(1).

9. 47 A.D.3d 676 (2nd Dept. 2008). See also, *Bildstein v. Atwater*, 222 A.D. 2d 545 (1st Dept. 1995) (dismissing claims against directors based on corporation's certificate of incorporation, which included directors exculpation provision); *Teacher's Retirement System of Louisiana v. York.*, 244 A.D.2d 231 (1st Dept. 1997).

10. N.Y. Real Property Law, Article 9-B, §§339-d to 339-kk (McKinney 2006 & 2010 Supp.).

11. N.Y. Bus. Corp. Law §717(a)(2) (McKinney 2003).

12. 75 N.Y. 2d 530. See also, *Board of Managers of Fairways at North Hills Condominium v. Fairways at North Hills*, 193 A.D.2d 322 (2nd Dept. 1993).

13. *Buffalo Forge Co. v. Ogden*, 555 F.Supp. 892, aff'd, 717 F.2d 757 (2d Cir. 1983).

14. In *Kleinman v. High Point of Hartsdale I Condominium*, 108 Misc.2d 581 (Sup. Ct. Westchester Co. 1979), the court ruled on what was then a novel question—whether members of a condominium board of managers could be held personally liable for the alleged failure to make repairs or making improper or inadequate repairs. The court held that they could not and dismissed all claims against the board members, finding that the offering plan exculpated board members from personal liability and that gratuitous board service should be "encouraged by exoneration from personal liability rather than be discouraged by imposition of personal and individual liability." 108 Misc.2d at 582.

15. See, e.g., *Silverman v. 875 Tenants Corp.*, 16 A.D.3d 248 (1st Dept. 2005); *Bryant v. One Beekman Tenants Corp.*, 73 A.D. 3d 616 (1st Dept. 2010); *Batsidis v. Wallack Management Company, Inc.*, 65 A.D.3d 332 (1st Dept. 2009).

16. GOL §5-321. (McKinney 2003).

17. *Hadzihanovic v. 155 E. 72nd St. Corp.*, 20 A.D.3d 637 (2nd Dept. 2010). See also, N.Y.C. Bar Association Web site, commentary on Model Form of Apartment Alteration Agreement, for suggested language to be used in apartment alteration agreements in light of this decision. Available at: http://www.abcny.org/RealEstate/Forms/Commentary_2010.doc

18. 2010 NY Slip Op 06149. This ruling is based on the long-standing "American Rule" that precludes the prevailing party from recouping legal fees from the losing party except where authorized by statute, agreement or court rule. *U.S. Underwriters Ins. Co. v. City Club Hotel, LLC*, 3 N.Y. 3d 592 (2004).

19. See, e.g. N.Y. Bus. Corp. Law §726(a) (McKinney 2003).

20. See, e.g. N.Y. Real Property Law, Article 9-B, §339-bb (McKinney 2006).

21. *Frontier Insulation Contrs. v. Merchants Mut. Ins. Co.*, 91 N.Y.2d 169, 175 (1997).

22. Joseph Warren Bishop, Jr., *The Law of Corporate Officers and Directors: Indemnification and Insurance* §8:28 (rev. ed. 2010).

23. *New York Marine and General Ins. Co. v. Lafarge North America, Inc.* 599 F.3d 102 (2d Cir. 2010), citing *Pub. Serv. Mut. Ins. Co. v. Goldfarb*, 53 N.Y.2d 392, 401 n. (1981).

24. In *Yardarm Condominium II v. Fed. Ins. Co.*, 247 A.D.2d 499 (2nd Dept. 1998), the insurer was found to have no duty to indemnify or defend when the court found the insurance policy, as a matter of law, clearly and unequivocally excluded property damages, irrespective of the alternative interpretation suggested by the board.

25. *Evanston Ins. Co. v. GAB Business Services, Inc.*, 132 A.D.2d 180 (1st Dept. 1987).

26. *Matter of Ancillary Receivership of Reliance Ins. Co.*, 55 A.D.3d 43 (1st Dept. 2008), aff'd, 12 N.Y.3d 725 (2009).

27. NYLJ, June 30, 1999 at pg. 27, col. 5 (N.Y. Sup. Ct.).

28. N.Y. Ins. Law §3420(a)(5).

29. N.Y. Ins. Law §3402(c)(2)(C). See *Biondi v. Beekman Hill House Apt. Corp.*, 257 A.D.2d 76 (1st Dept. 1999), aff'd, 94 N.Y.2d 659 (2000), where the court held, inter alia, that a co-op may not indemnify board members who unlawfully discriminate by rejecting prospective apartment purchasers on racial grounds.

30. See, e.g., *People v. Premier House, Inc.*, 174 Misc.2d 163 (N.Y. City Crim. Ct. 1997), where three co-op officers were charged with nine counts of violating §131.15(a) of the New York Health Code, the so-called "Window Guard Law", when a City inspection made after a child fell from a building and died found that nine apartments had faulty window guards. See, also, R. Siegler, "The Liability of Board Members," note 3 supra, for a discussion of additional laws affecting co-ops and condominiums that could lead to criminal sanctions for non-compliance.