Client Alert

pillsbury

Nonprofit Organizations

Litigation Health Care

March 27, 2015

Court of Appeals to Directors of Nonprofits: "Nonprofit" Does Not Mean "No Risk for You"

By Bruce A. Ericson, Jerald A. Jacobs and Marley Degner

The U.S. Court of Appeals for the Third Circuit recently upheld a $2.25 million jury verdict against the directors of a nonprofit nursing home, holding them personally liable for breach of their duty of care. Their sin? Failing to remove the nursing home's administrator and CFO "once the results of their mismanagement became apparent." While the court overturned a punitive damages verdict against five directors (the jury had found nine other directors liable for compensatory damages but not punitive damages), it upheld punitive damage awards of $1 million against the CFO and $750,000 against the Administrator. The decision, while unusual, illustrates that serving on a nonprofit board is not risk-free—even if, as in this case, the directors do not breach their duty of loyalty or engage in any self-dealing. In re Lemington Home for the Aged*, 777 F.3d 620 (3d Cir. 2015).*

The *Lemington Home* Case

Founded in 1883, the Lemington Home for the Aged was the oldest nonprofit unaffiliated nursing home in the United States dedicated to the care of African Americans. For decades, the Home had been "'beset with financial troubles'" and by the early 2000s it was being cited by the Pennsylvania Department of Health for deficiencies at a rate almost three times greater than the average.

In 2004, the Home's Administrator Causey started working part-time while continuing to draw a full salary. That same year, two patients died under suspicious circumstances; an investigation by the Department of Health found that Causey lacked the qualifications, knowledge and ability to perform her job. An earlier

independent review also recommended that Causey be replaced. Although the Board obtained a grant of over $175,000 to hire a new Administrator, the funds were used for other purposes and Causey stayed on.

The Home's patient recordkeeping and billing were in a state of disarray. The Home was cited repeatedly for failing to keep proper clinical records. CFO Shealey stopped keeping a general ledger, instead simply recording cash transactions on an Excel spreadsheet. When a consultant conducting an assessment of the Home for a major creditor requested records, Shealey responded by locking himself in his office, forcing the consultant to "camp outside." Shealey also failed to collect at least $500,000 from Medicare because he stopped sending invoices.

In January 2005, the Board voted to close the Home, but concealed that fact for three months before filing for bankruptcy. In those three months, the Home stopped accepting new patients, making it less attractive to potential buyers. While in bankruptcy, the Board failed to disclose in its monthly operating reports that the Home had received a $1.4 million payment, which could also have increased its chances of finding a buyer. The court held that these facts supported the jury's verdict that the defendants had "deepened" the corporation's insolvency, which the court said was actionable under Pennsylvania law. 777 F.3d at 630.

The court of appeals upheld the jury's compensatory damages verdict against the directors despite the Home's bylaw provision protecting the directors from claims for simple negligence and requiring proof of self-dealing, willful misconduct or recklessness. *Lemington,* No. 10-800, 2013 WL 2158543, at *6 (W.D. Penn. May 17, 2013). Both the court of appeals and the district court held that the evidence supported a finding that the directors breached their duty of care by recklessly (1) continuing to employ the Administrator despite actual knowledge of mismanagement and despite knowing that she was working only part-time in violation of state law; and (2) continuing to employ the CFO despite actual knowledge of mismanagement, including his failure to maintain financial records. 777 F.3d at 628-30; 2013 WL 2158543, at *7*; In re Lemington Home for the Aged*, 659 F. 3d 282, 286-87 (3d Cir. 2011). Despite these holdings, the court of appeals reversed the award of punitive damages against the five directors, holding that there was insufficient evidence that they possessed the requisite state of mind and no evidence of self-dealing. 777 F.3d at 634-35.

The Result in *Lemington Home*: Unusual But Not Unique

Lemington Home is not the only case in which a court has held that directors of a nonprofit breached their fiduciary duties. Other cases—some new and some old—show how directors of nonprofits sometimes find themselves in the crosshairs, especially after an institution fails.

- Perhaps the best-known case is *Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses & Missionaries*, 381 F. Supp. 1003 (D.D.C. 1974), where the district court held that the directors breached their fiduciary duties of care and loyalty by failing to supervise the nonprofit's finances and by approving transactions that involved self-dealing. The court found that the board's finance and investment committees had not met for over a decade, and the directors had left management of the nonprofit to two officers who worked largely without supervision. Nevertheless, the court declined to award money damages against the directors, opting instead to impose certain reforms on the board.

- Starting in 2007, seven years of litigation (and millions of dollars in legal fees) ensued between two nonprofits interested in the creation of a memorial to Armenians who died during the First World War and two of their directors; the nonprofits lost their claims against the directors and ended up having to indemnify them. The district court denied summary judgment on the issue of whether the directors had breached their fiduciary duties but then concluded after a bench trial that the directors' decisions and the

process by which they made them were reasonable and, even if the directors had breached their duty, the corporation could not show that it suffered injury as a result. *Armenian Genocide Museum and Memorial, Inc. v. The Cafesjian Family Foundation, Inc*., 691 F. Supp. 2d 132 (D.D.C. 2010); *Armenian Assembly of America, Inc., et al., v. Cafesjian*, 772 F. Supp. 2d 20 (D.D.C. 2011), *aff'd*, 758 F.3d 265, 275 (D.C. Cir. 2014).

- In 2010, the National Credit Union Administration sued the unpaid volunteer directors of Western Corporate Federal Credit Union seeking $6.8 billion in damages on account of the directors' alleged failure to supervise the credit union's investment decisions. The credit union had invested heavily in diversified portfolios of securitized mortgage-backed securities; when the credit crisis hit, the NCUA took over the credit union (much the way the FDIC takes over failed banks) and sued the former directors and officers. The district court granted the directors' motion to dismiss, holding that the directors were protected by the business judgment rule. *Nat'l Credit Union Admin. v. Siravo, et al.,* No. 10-1597, 2011 WL 8332969, *3 (C.D. Cal. July 7, 2011).[1] The officers did not fare as well; the court held that the business judgment rule did not protect them, and at least some officers ended up paying some money to the NCUA and suffering other sanctions.

These cases are unusual, which goes a long ways toward explaining the unusual rulings. Generally, absent fraud, bad faith, a conflict of interest, a wholesale abdication of responsibility, or decisions that are clearly unreasonable based on facts known at the time, the business judgment rule will protect directors of nonprofits from personal liability for a breach of the duty of care. But vindication can take years of litigation and lots of money.

What Are the Lessons of *Lemington Home*?

- You can be sued. To be sure, directors of for-profit corporations are sued far more often than directors of nonprofits, but directors of nonprofits can be sued, nonetheless.
- If you are sued, the litigation can go on for years and be very expensive—even if ultimately you are vindicated.
- Because litigation—even unmeritorious litigation—can be expensive, directors should not serve without the protection of adequate directors' and officers' insurance (D&O insurance).
- Directors of nonprofits, despite usually being volunteers, can face personal liability for breach of their fiduciary duties and will be held to much the same standard of care as directors of for-profit corporations.
- Some states have enacted statutes dealing specifically with nonprofit directors' duty of care. Pennsylvania has such a statute: 15 Pa. Cons. Stat. Ann. § 5712 (2011). *See Lemington*, 659 F.3d at 290. Likewise, California has such a statute: Cal. Corp. Code § 7231. But it is far from clear that these statutes offer directors of nonprofits any more protection than they offer directors of for-profit corporations; the differences are subtle, at best.
- The business judgment rule offers directors some protection, but it is not an all-purpose shield against claims based on dereliction of duty, let alone disloyalty or self-dealing. To gain the protection of the

[1] Two of the authors of this Alert represented all directors and one officer in this litigation.

business judgment rule, a director must be assiduous and informed before making decisions. Specifically:

- The board must supervise: it must ensure that the organization's management are qualified to perform their duties and are actually performing those duties. The failure of the directors in *Lemington Home* to do this led to their being jointly and severally liable for $2.25 million in damages 777 F.3d at 626, 628.

- The board must seek and follow independent expert advice where appropriate: the directors in *Lemington Home* failed to follow the recommendations of independent advisors to replace the Administrator, even after being awarded funds to do so. They also ignored the advice of their bankruptcy counsel. *Lemington*, 2013 WL 2158543, at *7.

- Special care must be taken if the nonprofit veers toward insolvency:
  - Before filing for bankruptcy, consider conducting a viability study. In vacating the award of summary judgment for defendants, the Third Circuit in *Lemington Home* noted that the Board declined to pursue a viability study before filing for bankruptcy and suggested that this called into question the adequacy of their pre-bankruptcy investigation. *Lemington*, 659 F.3d at 286, 292.

  - Beware the "deepening insolvency" theory. Although not recognized in every jurisdiction, the theory holds directors and officers accountable to creditors if their post-insolvency management increases the losses that creditors suffer.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the attorneys below.

Bruce A. Ericson (bio)
San Francisco
+1.415.983.1560
bruce.ericson@pillsburylaw.com

Jerald A. Jacobs (bio)
Washington, DC
+1.202.663.8011
jerry.jacobs@pillsburylaw.com

Marley Degner (bio)
San Francisco
+1.415.983.1186
marley.degner@pillsburylaw.com

Alvin Dunn (bio)
Washington, DC
+1.202.663.8355
alvin.dunn@pillsburylaw.com

About Pillsbury Winthrop Shaw Pittman LLP
Pillsbury is a full-service law firm with an industry focus on energy & natural resources, financial services including financial institutions, real estate & construction, and technology. Based in the world's major financial, technology and energy centers, Pillsbury counsels clients on global business, regulatory and litigation matters. We work in multidisciplinary teams that allow us to understand our clients' objectives, anticipate trends, and bring a 360-degree perspective to complex business and legal issues—helping clients to take greater advantage of new opportunities, meet and exceed their objectives, and better mitigate risk. This collaborative work style helps produce the results our clients seek.

This publication is issued periodically to keep Pillsbury Winthrop Shaw Pittman LLP clients and other interested parties informed of current legal developments that may affect or otherwise be of interest to them. The comments contained herein do not constitute legal opinion and should not be regarded as a substitute for legal advice.
© 2015 Pillsbury Winthrop Shaw Pittman LLP. All Rights Reserved.