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Sounding The D&O Liability Alarm For Health Nonprofits

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A few weeks ago, the United States Court of Appeals for the Third Circuit issued an important, 28-page opinion that confirmed a jury verdict, holding former officers and directors of a not-for-profit health care provider in bankruptcy, jointly and severally liable to the facility's creditors — in the amount of $2.25 million — for breach of fiduciary duty in failing to properly oversee and manage the nonprofit entity. Official Comm. of Unsecured Creditors ex rel. Lemington Home for Aged v. Baldwin (In re Lemington Home for Aged), No. 13-2707, at *1 (3d Cir. Jan. 26, 2015). In the same decision, the court upheld punitive damages of $1 million and $750,000 against two of the officers — the nursing home's administrator and chief financial officer — but reversed a punitive damages award against the directors.

While focused on Pennsylvania state law, regardless of jurisdiction, the Third Circuit's opinion provides a cautionary tale for the corporate officers as well as board members of not-for-profit health care organizations — for the most part, volunteers — that they may be held to the same standards of accountability as those of for-profit, public corporations. Additionally, in jurisdictions where the concept of "deepening insolvency" is recognized or gaining currency, officers and board members must be particularly vigilant to prevent actions that could exacerbate a struggling provider's financial condition. Under the "deepening insolvency" theory as stated in the decision, a director's duties extend to creditors whenever the provider is technically insolvent.[1]

This article discusses key aspects of the court's decision and takeaways for directors and officers of health care providers to mitigate the risk of personal liability, particularly in the event of a corporation's insolvency.

Facts Adduced at Trial

The Home for Aged and Infirm Colored Women was established in 1883 and operated as a nursing home in Pittsburgh from that time, being renamed as the Lemington Home for the Aged in 1900. In 1997, at the request of the home's board of directors, Hershberg Salter Associates developed a comprehensive long-range plan to remediate the home's image problems within the community as a health care provider, made more acute by a history of Pennsylvania Department of Health deficiency citations at a rate almost three times greater than the average nursing home operating in the state. Id. at *14. The long-range plan recommended, among other things, that the home replace the administrator and hire a "quality human resources staff," and outside specialists. In re Lemington Home for Aged, 659 F.3d 282, 287 (3d Cir. 2011), as amended (Oct. 20, 2011), subsequent mandamus proceeding sub nom. In re Baldwin, 700 F.3d 122 (3d Cir. 2012).

Another study, in 2001, funded by a community foundation, also recommended that the board replace the administrator with a "qualified, seasoned nursing home administrator" and "review, revamp and re-staff each department." Id. at 287. The community foundation provided a grant of more than $175,000 to hire a new administrator. The board did not act to replace the administrator, and the administrator instead used the grant monies for other purposes.

The home continued to be cited for deficiencies, including the failure to properly maintain residents' clinical records as well as lapses in care, eventually culminating in investigations into two patient deaths that occurred in 2004. The Pennsylvania Department of Health concluded that "'[the administrator] lacks the qualifications, the knowledge of the [applicable] regulations and the ability to direct staff to perform personal care services as required.'" Lemington, 2015 WL 305505, at *3. The board still did not replace the administrator, even after she had transitioned to part-time status, in violation of Pennsylvania law.

The board also failed to oversee the home's financial operations. The CFO hired by the directors ceased keeping a general ledger of accounting records in November 2003. Lemington, 659 F.3d 282 at 289. Beginning in August 2004, the CFO also failed to bill Medicare, resulting in a failure to collect approximately $500,000. By fall of 2004, the home's accounting firm declined to continue to work for the home for nonpayment of its bills, and a medical records and billing consultant terminated services in August of that same year due to nonpayment. Id. at 287.

From November 2003 through January 2005, the board position of treasurer, who was to chair the board's finance committee, remained vacant, contrary to the home's bylaws. Id. at 287. The board did not appoint any other members to the finance committee as required by the bylaws. Id. at 291. Consequently, the board's finance committee never met.

In January 2005, the board decided to close the nursing home, effectively depleting the patient census, and in March 2005, transferred the home's principal charitable asset, the endowment held by the community foundation, to Lemington Elder Care, an affiliate having overlapping directors. Id. at 288. In April 2005 and before the home filed for bankruptcy, the CFO unilaterally sought to broker the purchase of the home, including attempting to negotiate a sale that would provide the CFO with post-sale employment, as president and CEO of the home. Lemington, 2015 WL 305505, at *12.

The home did not file for Chapter 11 bankruptcy protection until April 13, 2005. After the home filed, the directors failed to disclose to the creditors committee their earlier decision to close the home. Id. at *17. In May 2005, when asked for basic financial information by the committee's consultant, the CFO locked himself in his office, but later falsely told the board that he had given the consultant all of the information requested. Id. at *11.

The creditors committee's consultant maintained that, by shuttering the nursing facility, shrinking the patient census, and delaying for three months the filing for bankruptcy during which time the directors continued to breach their fiduciary duties, continued to do business with vendors although they knew that the home was insolvent, failed to collect Medicare receivables and upheld a policy of no new patient admissions, the directors had removed any potential source of income for the home and made it an essentially worthless asset by the time the home filed for bankruptcy. Id. at *17, see also, Lemington, 659 F.3d 282, at 295.

Analysis

It is the rare case that directors and officers of a charitable corporation are found personally liable for breach of fiduciary duties. Nevertheless, the court's opinion in Lemington — analyzing the actions and inactions of the officers and directors of the home that led to the imposition of personal liability — provides a useful lens for examining the legal risks of directors and officers of nonprofit and for-profit alike health care providers.

Administrator

The court upheld the jury's finding that the administrator had failed to uphold her duty of care to the home by failing to act "with such care, including reasonable inquiry, skill and diligence, as a person of ordinary prudence would use under similar circumstances." 15 Pa. Cons. Stat. Ann. § 5712(a).

The court cited the considerable evidence adduced at trial of the administrator's mismanagement of the home, including: (a) failing to perform her responsibilities to ensure vendor contracts were in place, the facility was being managed financially, bills were being paid, and the facility was operating in compliance with federal and state regulations; and (b) continuing to serve and accept compensation as administrator even after converting to part-time status in violation of Pennsylvania law.

Additionally, the court sustained the jury's finding that the administrator had failed to discharge her duty of loyalty to the home — to devote herself to the corporate affairs of the home to further the home's interests over her own self-interest. Instead, she breached her duty of loyalty by collecting her full salary while not in fact fulfilling the duties of the role for which she was being compensated. The failures in fulfilling her duty of loyalty and the evidence of self-dealing were the basis for the punitive award against her; in particular, the court pointed to the administrator's diversion of grant monies earmarked to find her replacement, as well as her accepting a full-time salary intended to compensate a full-time administrator, as further support of the jury's verdict of punitive damages.

Chief Financial Officer

The court likewise sustained the jury's finding that the CFO had breached his duty of care, referring to the record evidence that the CFO had failed to maintain the home's books and records, had lied to the board about sharing information with the consultant, and had foregone collection of upwards of $500,000 in Medicare payments. The court also concluded that the evidence showed that CFO had acted in his self-interest and in breach of his duty of loyalty in attempting to broker a sale of the home that would elevate him to president and CEO. That same evidence of self-dealing was cited to support imposition of punitive damages against the CFO.

Board of Directors

The court also upheld the jury's finding that the individual directors had failed to exercise the requisite standard of reasonable prudence and care over the home's affairs in breach of their fiduciary duty, by continuing to employ the administrator and CFO despite actual knowledge of mismanagement and repeated deficiency citations. The court specifically noted that the board had received multiple reports citing the administrator's inexperience and lack of qualifications, and knew she was working part-time.

The board's failure to elect a treasurer and appoint a finance committee responsible for overseeing the CFO, in direct violation of its own bylaws, also constituted a breach of their duty of care. Finally, the court noted that the board had failed to keep minutes of its meetings — a basic corporate formality necessary to document a board's discharge of its oversight responsibilities.

The court, however, found the evidence insufficient to support a punitive damages award against the defendant directors. The court reasoned that the directors did not possess the requisite culpable state of mind — evidenced by "outrageous" or malicious conduct — to warrant the imposition of such an extreme remedy. The court contrasted the absence of evidence of self-interested conduct on the part of the directors with the trial record of self-dealing engaged in by the CFO and the administrator.

Deepening Insolvency

Under Pennsylvania law, "deepening insolvency" is defined as "an injury to a debtor's corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life." Lemington, 659 F.3d at 294 (citation omitted). The court noted that the board's failures and mismanagement of the bankruptcy process deepened the insolvency of the home, especially failing to disclose in its monthly operating reports that the home had received a $1.4 million "nursing home assessment tax" payment in May 2005, which could have increased the home's chances of finding a buyer.

Additionally, concealment of the board's determination to seek bankruptcy protection for three months exacerbated the home's losses. The court held the officers' mismanagement of the home's finances, inattention to record-keeping and patient billing, and their failure to establish a proper sale process within the bankruptcy, including the opportunity to bid for assets or review financial records, further dissipated the home's value when the home was already insolvent. The court upheld the jury's finding that the officers and directors' actions or inaction "deepened" the insolvency of the home.[2]

Takeaways

While this case involved extreme facts, the court's opinion is a useful reminder and aid for developing — and implementing — effective policies and practices that govern the conduct of officers and directors of health care providers, particularly in times of financial stress. Here are some of the key "takeaways":

1. The risk that officers and directors of not-for-profit corporations may be personally liable for breach of fiduciary duty is real. The officers and directors of the home in Lemington were held to essentially the same duties of care and loyalty as those applied to the officers and directors of a for-profit corporation. Although serving on a voluntary basis, the directors are still expected to commit the time and attention required to inform themselves of the organization's operations and finances and to inquire about — and take appropriate action to remediate — apparent irregularities.

2. To ensure that a health care provider organization is being well-run, the board should include individuals who know the industry and have the requisite financial and health care experience to competently oversee the organization and its executive staff. A savvy and well-informed board is also more likely to detect and prevent self-dealing and suspect transactions engaged in by officers and executives.

3. It is important for health care providers to, when necessary, hire and, when appropriate, actually heed the advice of independent professional consultants and counsel. On multiple occasions, the home’s board did not address the many disturbing reports it received from both the Department of Health and outside consultants about the home’s operations and finances.

4. There is an even heightened level of vigilance that the board must engage in when an organization is struggling financially. Depending on applicable state law, when a corporation is insolvent or in the “zone of insolvency,” a board may owe a duty to the corporation’s creditors in addition to their fiduciary duties to the corporation. Thus, it is critical that entities facing financial challenges be mindful of the interests of all of their constituents in making decisions that impact creditor recoveries.

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[1] A director’s duties may be extended to creditors in other jurisdictions under a related concept of operating within the “zone of insolvency.”

[2] Pennsylvania courts had never ruled on the issue of whether deepening insolvency was an independent cause of action, though, in a previous case, the Third Circuit had held that it believed “the Pennsylvania Supreme Court would determine that ‘deepening insolvency’ may give rise to a cognizable injury.” Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 349 (3d Cir. 2011). Neither Delaware nor New York has followed Pennsylvania’s path establishing deepening insolvency as an independent cause of action. Interestingly, the court notes in a footnote that they have “reserved opining on the question of whether deepening insolvency ‘may not apply to, or may involve a different standard for, a non-profit corporation,’ as no party had raised the argument.” Lemington, 2015 WL 35505, at *6 n.2.
