

New Guidance for Directors and Officers Issued by Third Circuit Court of Appeals

by

Steven T. Lawrence, Esq.
Shareholder
Milligan Lawless, P.C.
steve@milliganlawless.com
602-792-3536

A recent decision by a federal appellate court provides a stark reminder that liability can extend to directors and officers of both for-profit and non-profit entities for failing to observe fiduciary duties. *In Official Comm. Of Unsecured Creditors ex rel. Lemington Home for the Aged v. Baldwin (In re Lemington)*, No. 13-2707, 2015 WL 305505 (3rd Cir. 2015), the Third Circuit Court of Appeal found directors and officers individually responsible for mismanagement that rose to the level of a breach of fiduciary duties that were owed to the creditors when the organization became insolvent. This article briefly reviews the opinion and provides key action items for directors and officers to consider as they walk into their next meeting.

The Opinion

The *In Re Lemington* case arises out of alleged mismanagement of a Pittsburgh area nursing home. The Lemington Home for the Aged was the “oldest, non-profit unaffiliated nursing home in the United States,” having been established in 1883. After years of financial struggles, the Board of Directors voted to file a petition in bankruptcy on April 13, 2005. In November 2005, the Unsecured Creditors Committee was granted a request by the bankruptcy court to pursue an adversary proceeding against two former officers and 14 former directors of the nursing home claiming breaches of fiduciary duty, duty of loyalty and deepening insolvency. A trial was held and the jury found in favor of the plaintiff and awarded \$2.25 million in compensatory damages, \$350,000 in punitive damages against certain director defendants, \$1 million in punitive damages against the former Chief Executive Officer and \$750,000 against the former Chief Financial Officer. The Third Circuit Court of Appeals upheld the jury verdict regarding compensatory damages and punitive damages against the CEO and CFO (but overturned the punitive damage verdict as to certain director defendants).

The Lemington nursing home had a history of operational deficiencies and had a number of suspicious deaths. Throughout the CEO’s tenure, the home was not in compliance with federal or state law. The home was repeatedly cited for failing to keep proper documentation of residents’ clinical records. In the year prior to the bankruptcy filing, the Pennsylvania Department of Health conducted a review of the facility and concluded that the CEO lacked the qualifications to be CEO, knowledge of applicable regulations and the ability to lead staff. This evaluation came after the CEO had been in her role for more than six years. The jury also heard evidence that the CEO was not working at the facility on a full time basis, which was a violation of state law and known to the Board of Directors. The CFO failed for a period of time to complete even basic accounting and record keeping tasks for the nursing home and at one point stopped billing Medicare altogether.

As to the directors, the Third Circuit’s opinion notes that despite a large number of deficiencies found at the home and the conduct of the CEO and CFO described above, the Board failed to take action to remove the CEO or CFO or take other affirmative action to correct the deficiencies. Although the Board sought and obtained a grant from a foundation to search for a new chief administrator, the funds were never used to find a replacement for the CEO. The Board allowed the CEO to work on a part-time basis in violation of state law. The opinion specifically notes that “this is not a case where directors, acting in good-faith reliance ‘on information, opinions, reports or statements’ prepared by employees or experts, made a business decision to continue to employ an Administrator.” *Id.* at 15. The jury heard evidence that showed that the directors heard several independent reports of the situation at the nursing home and the CEO’s “shortcomings.” In addition, the Board failed to elect a Treasurer or appoint a finance committee in violation of its own bylaws.

The Third Circuit rejected the defendants’ argument that the plaintiff had introduced insufficient evidence to support the jury’s verdict that the defendants had deepened the nursing home’s insolvency. The Third Circuit noted that the director defendants concealed an apparent “internal” decision to close the nursing home and deplete the patient census. In the lower court, the jury had heard evidence that the Board’s decision to deplete the patient census was akin to a “slow death” that only made the nursing home’s insolvency worse. In addition, the Court noted that the CEO refused to meet with the nursing home’s major creditors and failed to make financial information available to potential buyers – all of these actions occurred when the nursing home had already become insolvent.

While the facts of the *In Re Lemington* case are extreme and the mismanagement severe, the case represents an opportunity for directors and officers to revisit and reconsider the foundations of their obligations. Although this may be repetitive for experienced directors and officers, it is important that every director and officer keep their eye on their obligations and the actions necessary to properly observe those duties. With that in mind, we turn to key takeaways from the Third Circuit’s decision.

Key Takeaways

The *In Re Lemington* decision presents some important reminders for anyone who sits on a Board of Directors. Below is a list of important reminders for every director or officer to consider:

- Officers and directors owe a fiduciary duty, a duty of care and a duty of loyalty to the organization. This is the starting point for any analysis of the issues faced by officers and directors.
- In this case, the duties owed by officers and directors were enforced by creditors. When an entity is insolvent, the duties shift to the creditors.
- Officers and directors can be held responsible for making matters worse in financially struggling entities. The cause of action for deepening insolvency is widely recognized by courts throughout the nation.
- Non-profit directors can be held equally responsible for their actions as their for-profit counterparts.

Many directors have busy lives outside the organization on which they serve. Showing up to a board meeting alone may be a personal victory. However, showing up will not be enough. Directors need to be competent and engaged and make informed decisions about the issues facing the enterprise. The standards for directors were recently emphasized in guidance published by the American Health Lawyers Association in collaboration with the Office of the Inspector General, Association of Healthcare Internal Auditors and the Health Care Compliance Association entitled *Practical Guidance for Healthcare Governing Boards on Compliance Oversight* (April 20, 2015). A great reminder provided in *Practical Guidance* states:

A critical element of effective oversight is the process of asking the right questions of management to determine the adequacy and effectiveness of the organization's compliance program, as well as the performance of those who develop and execute that program, and to make compliance a responsibility for all levels of management.

(Emphasis added.) If your directors and officers are not asking the right questions, it is time to revisit the obligations of directors and officers. We suggest that there are seven action items for any director or officer to take right now in light of the *In Re Lemington* decision.

Seven Action Items Right Now for Officers and Directors

1. Confirm the existence and terms for directors and officers insurance. Ask: what is the deductible? What are the exclusions?
2. Ensure that board members and officers understand their responsibilities and have the requisite skills and experience to serve.
3. Create an environment where officer and director responsibilities are taken seriously and respected.
4. Observe corporate formalities – record, review and approve minutes, appoint the necessary committees, etc.
5. The board should review the performance of the CEO and ensure qualified individuals serve in key roles in the organization.
6. Consider indemnification provisions in articles, bylaws or by separate agreement. Personal liability for officers and directors is real and the only way to recruit qualified, sophisticated candidates will be to provide individual protection through insurance and indemnity.
7. Significantly vet new officer and director recruits – any new additions to the board and officer ranks should be carefully reviewed and you should ensure that those individuals have sufficient qualifications.

Serving on a board or serving as an officer is not for the unwary. The *In Re Lemington* case serves notice that directors and officers cannot sit idly by and allow an organization to experience a “slow death” or flitter in the wind. Directors and officers must take up active roles and lead the organization, even in the face of insolvency.