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Nonprofit Governance and Fiduciary Duties: Court Holds Directors Personally Liable for Mismanagement

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A recent court ruling highlights the need for robust governance practices for nonprofits, particularly those facing financial difficulties. The Third Circuit Court of Appeals affirmed a jury's award of $2.25 million in compensatory damages against former directors and officers of a bankrupt nonprofit corporation - personal liability for breach of fiduciary duties and "deepening insolvency."[1] The court also affirmed punitive damages against the officer defendants, but vacated the award of punitive damages against the director defendants.

Interestingly, the action was initiated by the nonprofit's creditors.

Lemington Home for the Aged

The case indicates that directors may not be able to rely on the "business judgment rule" if they fail to (i) comply with the corporation's bylaws and exercise reasonable diligence (including by showing up for board meetings) to inform their actions, or (ii) act once they are aware of any mismanagement by the nonprofit's officers or employees.

The Lemington Home for the Aged, established in Pittsburgh in 1883, was a Pennsylvania nonprofit corporation that operated "the oldest, non-profit, unaffiliated nursing home in the United States dedicated to the care of African-America[n] seniors" (the "Home"). The Home's decades-long financial difficulties became particularly acute during the early 2000s, under the management of the directors and two officers: the chief executive officer and "Administrator" (the "Administrator") and the chief financial officer (the "CFO").

The directors allowed the Administrator to run the Home for six years in the face of abnormally high deficiency findings and independent reports documenting her shortcomings and recommending that she be replaced. Even after she ceased working at the Home full-time, in violation of state law, the directors allowed the Administrator to continue in her role and collect her full salary. In addition, the directors relied on the advice of the CFO (and even elevated him to a "CEO type" role), even after the directors discovered he was not maintaining the Home's financial records and failed to bill Medicare for at least $500,000.

The board was also in disarray. Minutes of board meetings, including those involving compensation decisions, were incomplete or non-existent. Attendance at board meetings was often below fifty percent and at least one director failed to participate in a single meeting over several years. Although the Home's bylaws required a finance committee with a treasurer as chairperson, the finance committee was not established and the position of treasurer remained unfilled.

[1] In re Lemington Home for the Aged, No. 13-2707 (3d Cir. Jan. 26, 2015).

Recommendations

The board of directors of a nonprofit corporation is ultimately responsible (sometimes financially, as in this case) for the nonprofit's management.

1. **Bylaws.** To ensure the board is running smoothly, and that directors can seek to meet their duty of care and thereby reduce their risk of personal liability, a board should regularly review and amend, if necessary, the bylaws of the nonprofit. The bylaws and the board's actual practices should be consistent (e.g., establish all committees required by the bylaws, ensure that the number of directors in office accords with the number or range called for in the bylaws, etc.).

2. **Term Limits and Turnover.** Limiting the number of terms a director may serve to prevent board stagnation and allow for fresh perspectives and leadership. However, term limits must be weighed against the risk of the artificial loss of qualified and experienced board members. Short term lengths and limits on the number of consecutive terms (as opposed to total number of terms) can help balance this risk. Allowing for staggered terms may ensure that experienced directors' terms do not expire at the same time. Vacancies in either director or officer positions should be filled as soon as possible, and directors that consistently fail to attend meetings should be reevaluated and replaced if necessary.

3. **Meetings and Minutes.** Board and committee meetings should be carefully planned and facilitated to foster full attendance, participation and thoughtful decision-making in the best interests of the nonprofit. Minutes of all board and committee meetings should be taken and retained with the corporation's records, and the minutes should include the names of the persons in attendance, what votes were taken, and how each director voted, including any objections or abstentions.

   In addition, when the board or a committee acts on any matters for which there are specialized voting rules, such as where there is or may be a conflict of interest or in setting executive compensation, the minutes should note how those rules were met.

   In many cases, the information or documents the directors relied on when making their decision should be appended to the minutes. Aside from being required by law, as is typical, board and committee meeting minutes may evidence that directors faithfully discharged their various fiduciary duties.

4. **Officer Evaluations.** Contractual obligations aside, officers serve at the pleasure and under the supervision of the board. It follows that officer evaluations should be a significant component of a board's responsibilities. Evaluations are critical to ensuring the officers are meeting the board's expectations and fulfilling their duties, delegated to them by the board, in managing the nonprofit's operations and finances. If the board becomes aware that an officer is not fulfilling his or her duties, immediate corrective action may be in the best interests of the nonprofit.

5. **Director Compensation.** The roles of directors of large and highly-regulated nonprofits have changed dramatically over the past decade. Board and committee members are expected to keep informed with respect to organizational, industry and regulatory developments, be prepared in advance of board and committee meetings, and contribute their expertise and judgment to advise management.

   Personal liability is a real concern even when reduced by statutory protections and insurance. As a result, an increasing number of nonprofits, particularly those primarily funded with program services revenue (e.g., healthcare, higher education, etc.), are paying directors' fees. Fixed annual fees appear to be replacing per-meeting fee structures.

   The fees are utilized to attract and retain qualified director candidates with substantive expertise and the willingness to face potential liability and increasing time demands.

   At the least, director fees may serve as a sort of moral deterrent to complacency. Even if the amount is relatively insignificant to an otherwise highly compensated or wealthy individual, now that they are being paid by the nonprofit, they would feel bad if they did not diligently prepare for and attend meetings. After all, you get what you pay for, and paid directors feel like they have to give nonprofits their money's worth.

Duty of Care and the Business Judgment Rule

The standard of conduct for directors of nonprofits generally requires that a director perform the duties of a director in good faith, in a manner that the director believes to be in the best interests of the corporation, and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances. A director's obligation to make reasonable inquiry generally arises when the circumstances indicate that further inquiry is needed.

The "business judgment rule" insulates directors from judicial intervention and liability, in the absence of fraud or self-dealing, if the directors exercise reasonable diligence and honestly and rationally believe their decisions are in the best interests of the corporation. Underlying the business judgment rule is the assumption that reasonable diligence has been used in reaching the decision which the rule is invoked to justify. Thus, it depends on whether the directors' reliance upon the information provided by one or more officers (or others) is in good faith, and whether there is a reasonable basis for relying upon such officers.

The court in Lemington Home for the Aged held that the evidence supported a finding that the directors breached their duty of care by failing to take action to remove the officers once the results of the officers' mismanagement became apparent. In other words, the directors did not exercise reasonable prudence and care in continuing to employ the two officers.

The court further noted that the board's failure to follow its own bylaws and continued reliance on the information provided by the two officers, in the face of numerous red flags as to such officers' competence and diligence, supported a rational conclusion that the directors did not exercise reasonable diligence. As a result, the court found that the business judgment rule should not shield the directors from liability.

Conclusion

The jury's award of $2.25 million in compensatory damages against former directors and officers of a nonprofit corporation is a stern reminder that both directors and officers of nonprofit corporations may be held personally liable for breaches of their fiduciary duties.

Nonprofit boards should regularly review and update their governance practices to ensure directors are meeting their fiduciary duties and reduce the risk of personal liability.

If you have any questions about this alert or nonprofit governance practices generally, please contact *Ofer Lion* at *olion@seyfarth.com*, *Douglas M. Mancino* at *dmancino@seyfarth.com*, or *Christian G. Canas* at *ccanas@seyfarth.com*.

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