2011 Issue 7

www.ober.com

Five Things Directors of Nonprofit Health Care Providers Can Learn from Lemington Home

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Recently, a federal appeals court in *In re Lemington Home for the Aged* revived claims brought by unsecured creditors against the directors and officers (D&Os) of the insolvent Lemington Home for the Aged when it reversed a lower court's decision in favor of the D&Os. The unsecured creditors committee asserted that the D&Os had breached their fiduciary duty to the unsecured creditors while wrapping up Lemington Home's corporate affairs. The committee further alleged that the D&Os had acted fraudulently in conveying assets to third parties, which led to Lemington Home's deepening insolvency.

Aside from this case's significance to the unsecured creditors committee, the court's discussion in this opinion may be a useful reminder to governing boards and officers of nonprofit health care providers. Governing boards and officers of nonprofit health care providers should consider the following five things when facing corporate decisions and the looming possibility of insolvency:

1. Reinforce the corporate formalities.

In *Lemington*, the committee alleged that the minutes of Board meetings were non-existent or incomplete, that one of the board members had failed to attend a meeting over several years, and that attendance at board meetings was often below 50 percent. The committee further argued that the board was out of touch with the operation of the home because the board had failed to appoint a treasurer or finance committee and that the board permitted the home's administrator to work part-time in a position that required a full-time employee. Each of these allegations supported the committee's argument that the board and the officers failed to exercise due care in the performance of their duties. Boards of directors and officers of nonprofits should remember to adhere to the corporate formalities, which

includes holding meetings, providing a simple agenda for the meeting, having a quorum at each meeting, appointing the appropriate officers, and approving minutes after each meeting.

2. Address apparent conflicts of interest.
Lemington Home's entire board of directors were also directors of an affiliate, Lemington Elder Care Services. The committee alleged that Lemington Home's board made decisions on behalf of Lemington Elder Care and not in the best interest of Lemington Home. The committee further alleged specifically that the Lemington Home board had transferred gifts from donors and trusts in the amount of $2.5 million from the moribund nursing home to Lemington Elder Care Services. Boards of directors can reduce the potentiality and veracity of such claims by requiring that independent, disinterested directors are appointed to the board (and the board of an affiliated entity) and by limiting approval of extraordinary actions to a majority vote of informed, disinterested directors. Both the disclosure of the conflict and the vote should be recorded in the minutes.

3. Record the board's receipt of reports from officers and outside experts and document the board's decision based on that advice.
In 2004, a $1 million loan was available to Lemington Home upon the completion of a viability study. In 2005, consultants and community health care providers advised Lemington Home to remain open because there was a significant need for its services in the community. One third-party consultant opined that Lemington Home could remain open if the management team was replaced and another third party independently provided a grant to Lemington Home to hire a new administrator. The court's review of these situations indicates that the board did not evaluate and act on these reports. Directors can rely in good faith on the reports made by employees and third parties and avail themselves of the business judgment rule if that decision is challenged later. The business judgment rule generally means that a reviewing court will not question a decision made by a corporation's governing board. It is a good practice to record the receipt of the report in the minutes and the board's response to that report.

4. Be flexible because the market for long term care services changes often.
The Lemington Home expanded its facility to 180 skilled nursing facility and assisted living facility beds in the 1980s in order to capture a broader market of payors, including Medicare, Medicaid and private-pay residents in Pittsburgh. At the time of its demise in 2005, 95 percent of Lemington Home's payor mix was from Medicaid and Lemington Home appeared to have been virtually insolvent for over a decade. It appeared that when the Lemington Home had an opportunity to make a change, the board or the administration was unable to make the necessary changes.

5. Recognize and balance many different duties — and seek advice when the duties contradict each other.
A nonprofit health care provider that is approaching insolvency has numerous obligations. In this case, Lemington Home's governing board took some steps which were reasonable and consistent with a director's fiduciary duty. For example, the directors sought the advice of counsel while coming to the conclusion to file for bankruptcy. However, nonprofit health care providers facing insolvency need to be mindful of other obligations. State licensing agencies and local departments of aging generally require long term care providers to provide a soft landing for the transfer or discharge of their residents. Insolvent, nonprofit entities have to consider the private inurement of its assets and other tax concerns. Lastly, when the provider is insolvent, the board's duties include a duty to the creditors arising out of the debts incurred before insolvency.

It is uncertain if the unsecured creditors committee will prevail in its breach of fiduciary duty and deepening insolvency claims. In general, claims brought as a breach of fiduciary duty are successfully defended under the business judgment rule. The court's ruling was based on preliminary fact-finding in support of the parties' summary judgment motions and it is possible that the D&Os would prevail after additional discovery. Further, the sustainability of the unsecured creditors committee's deepening insolvency claim is uncertain. In the meantime, nonprofit health care providers and their governing boards should consider the five issues discussed here. This consideration may result in a determination to change some of its business practices.