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Directors and Officers Beware: Could You Be Personally Liable?

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Now is the time for directors and officers of nonprofit health care providers to reassess their governance and compliance obligations to ensure that they do not inadvertently breach their fiduciary duties. The need for self evaluation stems from a cautionary opinion on fiduciary duties from the Third Circuit Court of Appeals and a collaborative publication on the duty of care and compliance from the United States Department of Health and Human Services ("HHS"). This article, the scope of which is limited to the obligations of directors and officers of nonprofit health care providers, examines the instances in which directors and officers may face liability.

Fiduciary Duties of Directors and Officers and Limits of Liability

Certain core fiduciary duties apply to all directors and officers of nonprofit health care providers. The duties of loyalty, care and obedience are among the most important directors and officers owe to their organization. [1] The duty of loyalty requires directors and officers to act in good faith and refrain from self dealing. Directors and officers must also not exploit any of the organization's business opportunities for their own personal gain. [2] Wisconsin courts apply a more restrictive duty of loyalty to nonprofit organizations than is standard in most states. [3] Most states only hold nonprofit organizations to the same standard as for profit organizations. [4] *In re Lemington Home for the Aged* , 777 F.3d 620 (3d Cir. 2015) ("Lemington"), makes clear that directors and officers of nonprofit organizations who breach their duty of loyalty risk both personal liability and punitive damages.The duty of care requires that directors and officers use the same degree of diligence, inquiry and skill in performing their duties as a prudent person would use in similar circumstances. [5] Directors and officers must make informed, good faith decisions to further the organization's purposes. [6] Given

POSTED:

Mar 15, 2016

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the complexity and fast paced nature of today's business world, the duty of care only requires that directors and officers be "reasonably" well informed before making a business decision. [7] Directors and officers who exercise their reasonable business judgment will generally fulfill their duty of care.The duty of obedience requires that directors and officers carry out the organization's purposes as set out in its organizational documents. [8] Directors and officers must act within the scope of the organization's mission. For example, directors and officers who do not use the organization's assets to further the organization's purposes as described in its charter may violate the duty of obedience. This duty is unique to—and necessary for—nonprofit organizations because they have no shareholders and the public needs assurance that its donations to the organization will only be used to fulfill its mission. [9]

Liability: Limited or Not?

Wisconsin's business judgment rule ("BJR") for non-stock corporations [10] protects directors and officers from personal liability arising from a breach or failure to perform any duty resulting solely from their status as officers or directors. [11] Directors and officers may be held personally liable if they do not disclose that their actions are on the organization's behalf. [12] If they disclose that they are acting on the organization's behalf, directors and officers will only be held personally liable if one of the BJR's exceptions applies. [13] The BJR does not protect directors and officers if the director or officer: (1) violates criminal law; (2) willfully fails to deal fairly; (3) gains an improper personal benefit; or (4) engages in willful misconduct. [14] Directors and officers may also be held personally liable for two broad types of self dealing: (a) if they willfully fail to deal fairly with the organization in connection with a matter in which they have a material conflict of interest; [15] and (2) if they enter into transactions from which they derive an improper personal benefit. [16] Transactions between directors and officers and the organization are valid if: (1) the officer or director disclosed his or her interest in the transaction, or it was previously known to the directors, committee or members that approved the contract or transaction by a vote or by written consent (excluding the interested director's vote); and (2) the transaction is fair and reasonable. [17] Directors and officers may be held personally liable for willful misconduct. Although "willful misconduct" is not specifically defined in the Wisconsin Statutes, it occurs when an officer or director's "predominant motive" is to effectuate the misconduct. [18] For example, in *IGL Wisconsin Awning, Tent & Trailer Co. v. Milwaukee Air & Water Show, Inc.* , a director was held personally liable

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for willful misconduct when his predominant motive was to prevent a creditor from collecting a debt. [19]

Indemnification

Wisconsin non-stock corporations must generally indemnify directors and officers for all reasonable expenses incurred in mounting a defense for acts taken on behalf of the non-stock corporation. [20] The articles of incorporation may further expand the corporation's indemnification obligations. [21] On the other hand, Wisconsin non-stock corporations may *not* indemnify officers or directors whose defenses fail because the breach or failure to perform a duty constitutes a violation of criminal law, a willful failure to deal fairly, a gain of an improper personal benefit or willful misconduct. [22]

D&O Liability Insurance

D&O liability insurance indemnifies directors and officers for liabilities they personally incur. To incentivize qualified individuals to serve, organizations often provide this coverage to their directors and officers. [23] D&O insurance often covers negligence, errors, omissions, breaches of duty, misstatements, or other wrongful acts while the director or officer is acting in his or her official capacity. [24] It is critical that directors and officers review their D&O policy language because, as with any contract, policies vary in their definitions, coverages, exclusions and conditions.

Lemington: Fiduciary Duties and Liability Risk

Although *Lemington* is an extreme example of what can happen when directors and officers fail to fulfill their fiduciary duties, [25] important lessons can be learned from the decision. Directors and officers who breach their duties by committing criminal acts or engaging in self dealing or willful misconduct will not be protected by D&O insurance or the BJR.Lemington Home for the Aged (the "Home") was a nonprofit nursing home that experienced prolonged financial and operational problems. The Home's board of directors voted to close the Home early in 2005, but concealed that fact for three months before filing for bankruptcy. In those intervening months, the Home stopped accepting new residents. The Home continued to take on debt, but did not inform its creditors

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of its pending bankruptcy.Under the "deepening insolvency theory" (recognized in Pennsylvania and a minority of jurisdictions), the Home's unsecured creditor committee sued the Home's directors and officers for breaching their fiduciary duties. In the United States District Court for the Western District of Pennsylvania, [26] a jury awarded the plaintiffs $2.25 million in compensatory damages, and the judge imposed punitive damages against two officers and five directors—including $1 million against the Home's administrator and $750,000 against the Home's CFO. Upon appeal, the Third Circuit upheld both the compensatory and punitive damages.The trial court determined that the administrator and CFO were both incompetent, breached their duties of care and loyalty, and engaged in self interested acts and self dealing. [27] For example, the administrator/CEO worked at the Home for 17 years, yet during her tenure, the Home did not maintain adequate medical records; was cited for operational deficiencies at 3 times the normal rate; and had a number of suspicious resident deaths. Pennsylvania inspectors reported that the administrator was not qualified for the position. [28] The administrator also violated state law by collecting a full time salary while only working on a part time basis. The longstanding CFO did not manage a general ledger for years and failed to collect more than $500,000 from Medicare. The CFO also failed to generate financial reports and deliberately evaded creditors.The court also held that the board of directors failed to uphold its duties of loyalty and care. Not only did the board fail to hire qualified officers, but it failed to supervise and remove the administrator and CFO once their mismanagement became apparent. The board did not meet regularly, maintain appropriate minutes, elect a Treasurer or appoint a finance committee. The board ignored its financial problems, consciously deferred filing for bankruptcy, ceased admitting new residents (resulting in a significantly reduced patient census) and failed to establish a reasonable sale process.While *Lemington* was resolved under Pennsylvania law, nonprofit health care providers around the country should take note and make any necessary adjustments. *Lemington* makes clear that directors and officers of nonprofit organizations will be held to at least the same fiduciary standards as for profit corporations. If a nonprofit organization is financially struggling or insolvent, the directors and officers face a heightened risk, especially in those few states (including Pennsylvania) that recognize the tort theory of deepening insolvency. Such directors and officers need to take particular care to fulfill their duties and minimize their risk of liability. The same is true for directors and officers of for profit corporations, where the directors and officers must fulfill their fiduciary duties vis à vis a potential merger or acquisition, or providing cybersecurity oversight. Wisconsin does not currently recognize the deepening insolvency

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theory.Directors and officers of organizations with financial and/or operational problems often feel overwhelmed, and fear losing their jobs. They often fail to adequately communicate with the organization's board of directors. As a result, the board may assume that no problems exist. Even if the board is made aware of the organization's financial problems, directors may lack the expertise to fully understand the extent of the problems, or even know who to consult for help.The following precautions will help directors and officers avoid being held personally liable for breach of fiduciary duty:

1. Understand the organization's corporate structure and its purpose, mission and activities;
2. Attend board and committee meetings and ask pointed questions;
3. When appropriate, voice any concerns or objections to the organization's activities, and insist that any disapproval be recorded in the minutes;
4. Review any and all written reports and recommendations on which the organization's board bases its decision, and have the record reflect such reliance;
5. Ensure that the organization has a conflict of interest policy;
6. Disclose, in writing or orally for the meeting minutes, any conflict of interest or personal gain arising from any board action, and do not vote on such matters;
7. Do not enter into any agreement with the organization in which benefits received are not clearly fair and proper, and very cautiously approve loans by the organization to its directors and officers;
8. Maintain evidence of competence of all individuals who have significant responsibilities within the organization;
9. When appropriate, require that the organization's board consult legal counsel or other experts;
10. Ensure that the organization maintains adequate insurance; and
11. Ensure that the organization, not its officers or directors, signs written contracts.[29]

Steps to Minimize the Risk of Compliance Liability

In 2015, HHS published *Practical Guidance for Health Care Governing Boards on Compliance Oversight* ("Practical Guidance"). The Practical Guidance addresses the need for boards of directors to actively ensure compliance with laws and regulations as part of their duty of care. Boards of directors can take a number of

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steps to ensure that they adequately oversee their organization's compliance, including making inquiries to ensure that: (1) a corporate information and reporting system exists; and (2) said reporting system will adequately, timely and as a matter of course communicate to the board all appropriate information relating to compliance with applicable laws. [30] Prosecutors may also consider whether boards have adequately monitored compliance when determining damages in the false claims settlement process. [31] Compliance program designs are not "one size fits all." Boards are expected to put forth a meaningful effort to review the adequacy of existing compliance systems and functions. The scope and adequacy of compliance programs should correspond to the size and complexity of the organization. Although not every organization will be able to implement all the recommendations listed below, key action items may include:

- Developing a formal plan to stay informed about the applicable regulations and the operating environment;
- Adding to the organization's board, or otherwise consulting, an experienced regulatory, compliance or legal professional;
- Defining the interrelationship among the audit, compliance and legal functions in charters or other organizational documents;
- Evaluating the adequacy, independence and performance of the different functions within the organization on a regular basis;
- Implementing a process to ensure each function's appropriate access to information;
- Evaluating how management works together to address risk;
- Understanding how management approaches conflicts with respect to the resolution of compliance issues and how it decides on a course of action;
- Setting and enforcing expectations for receiving particular types of compliance related information from management;
- Conducting sessions (without senior management) with leadership from compliance, legal, internal audit and quality functions to encourage open communication;
- Ensuring that the organization implements solid processes for identifying risks;
- Ensuring that management consistently reviews and audits risk areas; and
- Encouraging self identification of compliance failures and voluntarily disclosing such failures to the government.

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Conclusion

Directors and officers must satisfy their fiduciary duties or risk significant personal liability. To avoid breaching their fiduciary duties, directors and officers need to understand what is required under the duty of care and the duty of loyalty. Fiduciary duties expand well beyond taking action to secure the organization's financial health. Directors and officers must carry out all of their obligations in accordance with their fiduciary duties. Although some nonprofit health care providers are financially struggling as a result of declining patient volumes, increased operating costs, the move from cost based to value based government compensation, and the Patient Protection and Affordable Care Act, directors and officers need to know that the organization's financial hardship does not excuse a breach of fiduciary duty.If you have any questions about the obligations of directors and officers, please contact Robert Heath .

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[1] *See* Thomas K. Hyatt & Bruce R. Hopkins, *The Law of Tax Exempt Healthcare Organizations* , 880 83 (4th ed. 2013). [2] *See* Wis. Stat. §§ 181.0831 and 181.0855. [3] Wisconsin's fiduciary duty common law and the Wisconsin Uniform Fiduciaries Act, Wis. Stat. § 112.01, *et seq.* , impose a strict duty of loyalty. The strict standard is appropriate for nonprofit organizations, given their lack of shareholders and the fact that their patrons cannot easily protect their own interests. *See* Thomas L. Fren, The Roles of Directors and Officers, *A Guide for Wisconsin Nonprofit Organizations* , § 3.92 (State Bar of Wisconsin Ed. 2015). [4] *Official Comm. of Unsecured Creditors ex rel. Estate of Lemington Home for the Aged v. Baldwin* , No. 10CV800, 2013 WL 2158543 (W.D. Pa. May 17, 2013) *aff'd in part, vacated in part sub nom.* [5] *See, e.g.* , Revised Model Nonprofit Corporation Act § 8.30(a). [6] *See* Hyatt & Hopkins, *supra* n.2, at 882. [7] *See id.* ; Wis. Stat. § 181.0850 (allowing O&Ds to rely on information from other officers, employees, professionals, experts and board committees). [8] *See* Hyatt & Hopkins, *supra* n.2 at 883. [9] *See id.* [10] This article refers both to nonprofit corporations and nonprofit organizations. A non-stock corporation is a corporation without capital stock; whereas, a nonprofit organization is an organization that uses surplus revenues to further achieve its purpose or mission. Nonprofit organizations in Wisconsin are organized as non-stock corporations under Chapter 181 of the Wisconsin Statutes. [11] *See* Wis. Stat. § 181.0855; *Benjamin Plumbing, Inc. v. Barnes* , 162 Wis. 2d 837, 470 N.W.2d 888 (1991). [12] *See Benjamin Plumbing* , 162 Wis. 2d at 859 60. [13] *See IGL Wisconsin Awning, Tent & Trailer Co. v. Milwaukee Air & Water Show, Inc.* , 185 Wis. 2d 864, 874, 520 N.W.2d 279 (Ct. App. 1994). [14] *See* Wis.

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Stat. § 181.0855. Limited liability for directors and officers of non-stock corporations under the business judgment rule does not extend to proceedings brought by or on the government's behalf, proceedings brought for violations of state or federal laws pursuant to an express private right of action, and unlawful distributions. Wis. Stat. §§ 181.0855(2), (3), 181.0832, 181.0833. In addition, remaining areas of personal liability for O&Ds may include: tax, worker's compensation, unemployment insurance, liability to investors under securities law, fundraising activities, antidiscrimination laws, and environmental law. *See* Polaski, et al., Liability Issues and Insurance Needs, *A Guide for Wisconsin Nonprofit Organizations* , § 4.23 (State Bar of Wisconsin Ed. 2015). [15] *See* Wis. Stat. § 181.0855(1)(a). [16] *See* Wis. Stat. § 181.0855(1)(c). [17] *See* Wis. Stat. § 181.0831(1). [18] *See IGL Wisconsin Awning* , 185 Wis. 2d at 876. [19] *Id.* [20] *See* Wis. Stat. § 181.0872. [21] *See* Wis. Stat. §§ 181.0875 and 181.0877(1). [22] Wis. Stat. § 181.0872(2)(a). [23] Wis. Stat. § 181.0883. [24] *See* Polaski, et al., *supra* n.16, § 4.82. [25] *Lemington* , 777 F.3d 620. [26] *Official Comm. of Unsecured Creditors ex rel. Estate of Lemington Home for the Aged v. Baldwin* , No. 10CV800, 2013 WL 2158543 (W.D. Pa. May 17, 2013) *aff'd in part, vacated in part sub nom. In re Lemington Home for the Aged* , 777 F.3d 620 (3d Cir. 2015). [27] *See Lemington* , 777 F.3d at 626 28. [28] *Id.* at 627. [29] *See* Polaski, et al., *supra* n.16, § 4.43. [30] *Id.* [31] *See* "New OIG Guidance on Board Oversight Could Be a Compliance Game Changer," *Report on Medicare Compliance* (Apr. 27, 2015).

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