FIDUCIARY DUTY IN 2014

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SECTION 1
Duties of Directors

I. Overview

We know that directors and officers of a nonprofit corporation hold a fiduciary duty. But, what is a fiduciary? The dictionary definition of a fiduciary means “of or relating to a holding of something in trust for another.” In the nonprofit world, “another” is the nonprofit entity itself as well as for the benefit of the public.

In 2014, the term fiduciary and the impact it has on the role of directors, is more heightened than we have seen in many years. Looking back over the past 15 years, we have seen many changes.

First, following the Allegheny Health Education and Research Foundation bankruptcy in 1998, nonprofit hospitals' boards of directors began being held to a higher standard of corporate governance. No longer would it be acceptable for nonprofit hospital board members to simply rubber stamp the actions of management. Core legal requirements for nonprofit directors, such as exercising their duty of loyalty and duty of care, would become enforceable obligations. Over the following few years, corporate scandals such as Enron, World Com, Health South and Arthur Anderson would further highlight the risks of poor corporate governance.

Then in 2002, in order to attempt to rebuild trust in corporate America, congress passed the American Competitiveness and Corporate Accountability Act of 2002 ("Sarbanes-Oxley"). While virtually all of Sarbanes-Oxley applies only to publicly traded companies, it became a wake-up call to nonprofit organizations.

While nonprofits are not bound by Sarbanes-Oxley, there are, however, sections of Sarbanes-Oxley which provide guidance for nonprofits and which nonprofit hospital boards should seriously consider. The first of which is the establishment of an independent audit committee. Like under Sarbanes-Oxley, the nonprofit hospital board audit committee should be comprised of independent directors (not management) who do not receive compensation (directly or indirectly) for serving on the audit committee. At least one member of the audit committee should qualify as a financial expert. The tasks of the audit committee would include overseeing the hospital's independent auditor, setting compensation and establishing procedures for handling complaints regarding internal financial matters. Additionally, all board members, as part of their board training, should receive basic financial literacy training so that they can understand board financial reports and budgets.

Under Sarbanes-Oxley, the company CEO and CFO must certify the company's financial statements. While nonprofit CEOs and CFOs do not have the same legal responsibility, such individuals should fully review all Form 990's before filing to ensure accuracy and completeness. Also, all audit reports should be fully reviewed by both the CEO and CFO.

Sarbanes-Oxley's whistleblower protections should also be carried over to the nonprofit sector with respect to accounting practices and other financial matters. Hospitals should review their whistleblower policies relating to fraud and abuse to see if they include mechanisms for reporting (and protection from retaliation for reporting) matters relating to accounting practices and other financial matters.

The document destruction protections set forth in Sarbanes-Oxley also should be applicable to nonprofit hospitals. While most hospitals have in place stringent document retention policies, these should be reviewed to ensure that they include electronic files and financial and other business records.

Now in 2014, funding for nonprofits has been significantly reduced, the need for nonprofit services has significantly increased and reimbursement for nonprofit healthcare services has been cut. Each of these factors has contributed to many nonprofits: (i) shutting down their doors; (ii) dissolving; (iii) entering into strategic affiliations with other nonprofits; and/or (iv) becoming part of a larger nonprofit or for-profit system. The common factor is often that the nonprofit can no longer survive on its own. This potential failure raises the question of whether the failure was due to: (i) the economic times and circumstances; (ii) a breach of fiduciary duty by the directors and officers; or (iii) decisions by the officers and directors that are covered by the business judgment rule.

In December 2013, the Tribune Review reported that Pennsylvania Attorney General, Kathleen Kane was investigating two Western Pennsylvania nonprofit corporations: The August Wilson Center and Conneaut Lake Park. Each of these cases came under review by the Office of Attorney General following financial difficulties. Specifically, in Conneaut Lake Park, the Tribune Review reported, that the trustees failed to pay taxes and maintain fire insurance on its ballroom that was destroyed in 2007. With respect to the August Wilson Center, the nonprofit fell behind on its mortgage payments, ending in foreclosure. In the article, Jon Peters, a spokesperson for the Attorney General Kane, stated that "the office has a responsibility to hold board members to their fiduciary duty under the Commonwealth Attorneys Act[1] … and when someone takes a position on a board, they knowingly take on that fiduciary obligation." The question arises as to whether or not there was a breach of fiduciary duty by the boards. Even if no breach occurred, no nonprofit volunteer director wants his or her name, or the organization he or she serves, in the newspaper in connection with an investigation or subject to an investigation by the Attorney General's Office.

We are in an era of evolving responsibilities for directors due in part to increased governmental oversight and the IRS' emphasis on scrutiny and transparency. Lax institutional governance patterns will no longer be tolerated and directors must be well versed in their corporate and fiduciary responsibilities.

II. Duty of Care.

Under a duty of care, directors, officers and senior managers of a nonprofit organization must use the degree of care, skill, caution and diligence that a prudent person would use in handling

[1] Commonwealth Attorneys Act, 71 P.S. § 732, *et seq*.

corporate affairs. See 15 Pa. C.S. § 5712. Decision-makers are required to make reasonable inquiries when analyzing contracts, investments, business dealings, and other matters. As a practical matter, at a minimum, directors should: (i) attend and participate in board and committee meetings on a regular basis; (ii) diligently read, review and inquire about material and information; (iii) keep abreast of affairs and finances of the entity; (iv) use independent judgment when analyzing matters relating to the affairs of the entity; (v) review policies relating to capital expenditures and officer expenses; (vi) review the organization's compensation policy annually; and (vii) review and complete conflict of interest policy annually.

In addition to the foregoing, directors should attempt to require that the nonprofit: (i) retain appropriate advisors; (ii) conduct orientation and continuing training for board members; and (iii) maintain adequate records. Moreover, directors should insist that their rights are maintained. Specifically, board members have the following rights: (i) to receive information; (ii) to call special meetings; (iii) to bring court actions to contest activities that affect their rights and duties; and (iv) to disagree with actions taken and have such disagreement noted in minutes.

While directors are responsible for representing the public's interest and being keepers of the public's charitable assets, directors are not guarantors of a nonprofit's success. See Pennsylvania Attorney General's View on Director Standard of Care - "Handbook for Charitable Nonprofit Organizations". This is especially true today in this very difficult economic climate for nonprofits. The exercise of proper business judgment does not always lead to success.

III. Duty of Loyalty.

Under a duty of loyalty, directors must exercise powers in the interests of the entity and not in their own interests or the interests of another. Examples of duty of loyalty concerns include: (i) conflicts of interest; (ii) usurping corporate opportunities; (iii) a duty of confidentiality; and (iv) competition with the nonprofit corporation.

Specifically, the duty of loyalty requires that a director be conscious of possible conflict of interest situations and act with candor and care in dealing with conflicts. Board members must always perform their duties in good faith with the best interests of the organization in mind. This means that they must not seek to derive private gain from business transactions that involve the nonprofit corporation or advance their own interests at the expense of the corporation. Board members should avoid conflicts of interest and even the appearance of impropriety. Individuals who take advantage of corporate opportunities to make profits for themselves at the expense of the corporation may be liable for the profits they received at the organization's expense.

In order to avoid conflicts of interests as well as the appearance of a conflict of interest, nonprofit corporations should have in place a conflict of interest policy and should enforce such policy. A conflict of interest policy, should at a minimum: (i) identify persons who may become involved in conflict situations; (ii) identify duties of such persons (i.e. who investigates, recusal issues, etc.); (iii) mandate disclosure; (iv) provide for conflict resolution; and (v) set forth a mechanism to monitor compliance. Disclosures of conflicts must be timely in order to allow the organization to address issues before they ripen into problems. The lack of disclosure exposes both the affected director and the rest of the board to a greater risk. Appropriate disclosure permits the remaining board members to evaluate the fairness of the transaction in light of all the facts.

IV. The Business Judgment Rule

The business judgment rule is a standard of review, not of conduct, and is based on the premise that directors must take business risks. The business judgment rule creates a presumption that, in making a business decision, the director acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the corporation. If a plaintiff can prove that the directors did not adhere to their duties of care or loyalty, the burden shifts to the directors to prove that the action or transaction was intrinsically or entirely fair to the corporation. This presumption is most likely to be rebutted where directors have conflicts of interest. Where conflicts exist, the benefits of the business judgment rule may, under certain circumstances, be preserved if action is approved by a majority of disinterested directors or members.

In Pennsylvania, in making a decision, a director must take into account the mission and purpose of the nonprofit, but may also consider the effect on: (i) employees; (ii) suppliers and customers; (iii) communities where offices are located; and (iv) other relevant factors.

A recent Commonwealth Court case in Pennsylvania highlights that a nonprofit must follow its articles and bylaws in making decisions. On November 27, 2013, in *Zampogna v. Law Enforcement Health Benefits*, the Commonwealth Court, in granting a prospective preliminary judgment, found that the board of directors violated Pennsylvania nonprofit law and the corporation's bylaws and articles by sending out a mailing endorsing a political candidate where such purpose was not an express purpose under the organization's articles and bylaws. The two person dissent raised concerns that this decision creates uncertainty and encourages litigation over the discretion of directors. See Zampogna v. Law Enforcement Health Benefits, Inc., No. 1322 C.D. 2012, 2013 WL 6190186 (Pa. Commw. Ct. Nov. 27, 2013). This case also highlights the duty of directors to follow the duty of obedience in carrying out its duties.

V. Lemington Homes for the Aged.

Lemington Home for the Aged ("Lemington") was originally incorporated in 1883 and was affiliated with Lemington Elder Care Services, with an interlocking board of directors. In 1983, Lemington moved its nursing home to Lincoln Avenue in Pittsburgh and expanded its bed count to 180. Lemington had consistent financial difficulties over the years and in 1999 was insolvent. In 2002 and 2003, Lemington's audits contained going concern warnings. Lemington hired a new CFO in 2002, but the new CFO failed to maintain a general ledger, and Lemington's financial and billing records "were in deplorable condition" and significant amounts went uncollected from Medicare and Medicaid. In March of 2004, the board was informed that employee insurance payments had not been made, notwithstanding the payroll deductions made by Lemington. There were also problems with Lemington's CEO, and the home was cited for numerous operating violations, including 22 nursing violations. In mid-2004, due to health problems, the CEO began working part time, even though state law required Lemington to have a full time administrator. Furthermore, in July 2006, a resident of the home died and he was not resuscitated, despite an advanced directive to the contrary. A second death at the home occurred later that year.

Lemington's problems also extended to its board of directors. For two years, the board treasurer position was empty, and there was no meaningful oversight of the financial operations during this period. Instead, the board relied on the CFO, even after they were aware that the CFO was not keeping financial records. There were additional board issues, including: (i) board minutes were incomplete or non-existent; (ii) minutes were not kept for executive sessions, including those involving compensation decisions; (iii) attendance at board meetings was often below 50%; and (iv) either delaying taking action with respect to bankruptcy or possible affiliations or acting against the advice of counsel.

Claims against the directors, the CFO and the CEO included a deepening insolvency claim and claims for breaches of fiduciary duty, including the duty of care and duty of loyalty (against the CFO and CEO). Following a jury trial, the jury returned a verdict against 15 of the 17 defendants, jointly and severally, in the amount of $2,250,000. The jury also awarded punitive damages against certain of the directors in the amount of $350,000 individually, and in the amount of $1,000,000 against the CFO and $750,000 against the CEO. See Official Committee 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).

VI. IRS Nonprofit Governance Principles

The IRS, in its Compliance Guide for 501(c)(3) public charities and on Form 990, has set forth a number of governance practices that a nonprofit organization should have in place. These include the following:

1. Mission. The IRS encourages charities to adopt, establish and review regularly the organization's mission statement to explain the organization's purpose and guide its work.

2. Governing Body. The IRS encourages an active and engaged board and suggests that governing boards are comprised of persons who are informed and active in overseeing a charity's operations and finances. A governing board should be composed of persons who are informed and active in overseeing the organization's operations and finances. The IRS recommends that boards include independent members and that boards are not dominated by employees or others who are not independent (including those with family and/or business relationships).

3. Governance and Management Policies. The IRS does not require that charities have particular governance or management policies; however, the IRS does encourage boards to consider whether the implementation of policies relating to executive compensation, conflicts of interests, investments, fundraising, documentation of governance decisions, document retention and whistleblower claims may be necessary and appropriate.

4. Financial Statements and Form 990 Reporting. The IRS encourages board members to regularly review the organization's financial statements and information returns and to consider whether an independent auditor is appropriate.

5. Transparency. The IRS encourages organizations to adopt and monitor procedures to ensure that information about their mission, activities, finance and governance is made publicly available.

SECTION 2
ATTORNEY GENERAL COMPLIANCE IN HEALTH CARE TRANSACTIONS

I. Overview of regulations governing nonprofit entities.

A. Statutory Provisions.

1. Section 5547 (b) of the Nonprofit Corporation Law provides that:

> (b) Nondiversion of certain property. – Property committed to charitable purposes shall not...be diverted from the objects to which it was donated, granted or devised, unless and until the board of directors or other body obtains from the court an order under 20 Pa. C.S. Ch. 77 Subch. D (relating to creation, validity, modification and termination of trust) specifying the disposition of the property (footnote omitted.) 15 Pa. C.S. § 5547(b).

2. Sections 5930(a) and (b) of the Nonprofit Corporation Law provide that:

> (a) General Rule. – A nonprofit corporation shall not sell, lease away or exchange all, or substantially all, of its property and assets, with or without good will, unless and until a plan of sale, lease or exchange of assets with respect thereto shall have been adopted by the corporation in the manner provided in this subchapter with respect to the adoption of a plan of merger. In order to make effective any plan of sale, lease or exchange of assets so adopted it shall not be necessary to file any articles or other document in the Department of State, but the corporation shall comply with the requirements of Section 5547(b) (relating to the nondivision of certain property).

> (b) Exceptions. – Subsection (a) of this section shall not apply to a sale, lease away or exchange of all, or substantially all, the property and assets of a corporation when made in connection with the dissolution or liquidation of the corporation. Such a

> transaction shall be governed by the provisions of Subchapter F (relating to voluntary dissolution and winding up) or Subchapter G (relating to involuntary liquidation and dissolution) as the case may be.

B. Case Law:

"[A]ll property held by a nonprofit corporation is held in trust to carry out its charitable purposes. All property held by a charitable nonprofit including the operating revenues, grants, donations, bequests, etc. generated therefrom, constitute property committed to a charitable purpose." In Re Roxborough Memorial Hospital, 17 Fiduc. Rep. 2d 412, 423 (1997).

"Whenever a Pennsylvania nonprofit corporation undertakes any action governed by 15 Pa. C.S.A. Chapter 59, review by the Court is required to determine whether or not property committed to charitable purposes will be diverted from its intended purposes. If as a result of a proceeding under Chapter 59 a division will result, the Court shall enter an order pursuant [to] 20 Pa. C.S.A. Chapter 61." In Re Roxborough Memorial Hospital, 17 Fiduc. Rep. 2d 412, 424 (1997).

"Property committed to charitable purposes means all property committed to the relief of poverty, the advancement of education, the advancement of religion, the promotion of health, governmental or municipal purposes, and other purposes the accomplishment of which is beneficial to the community… Because Christian Memorial Mission was charitable, the assets involved are charitable." In re Stroudsburg Real Property, 23 Fiduc. Rep. 2d 258 (O.C. Monroe 2003).

C. Attorney General Review Protocol For Fundamental Change Transactions Affecting Health Care Nonprofits (the "Protocol").

The Protocol was approved by the Commonwealth of Pennsylvania, Office of Attorney General on December 23, 1997. Under the Protocol, the Attorney General's Office, in its role as parens patriae, will review each nonprofit charitable health care entity transaction which effects a fundamental corporate change involving a transfer of ownership or control of charitable assets, regardless of the form of the contemplated transaction and regardless of whether the other party or parties to the transaction are nonprofit, mutual benefit or for-profit entities, unless the proposed transaction is in the usual and regular course of the nonprofit's activities. The purpose of the Protocol is to ensure that the public interest in the charitable assets of the nonprofit organization is fully protected.

II. What transactions are covered under the Protocol?

A. Breadth of Protocol.

The Protocol broadly defines the transfer of ownership or control of charitable assets to include a sale, merger, consolidation, lease, option, conveyance, exchange, transfer, joint venture, affiliation, management agreement or collaboration agreement, or other methods of disposition.

B. Fairness opinions.

Since the Protocol requires that the transaction be fair to the nonprofit in the eyes of the Attorney General, the modern trend is for the facility to obtain an independent third-party fairness opinion or valuation. Moreover, obtaining a fairness opinion helps to satisfy a director's duty of care, including reasonable inquiry, to the organization. See Smith v. Van Gorkom, 488 A. 2d. 858 (Del. 1985).

C. Dissolution of the corporate entity.

The requirements for the dissolution of a Pennsylvania nonprofit corporation are set forth in Subchapters F and G of the Pennsylvania Nonprofit Corporation Law of 1988, as amended. See also 15 Pa. Cons. Stat. Ann. § 5930(b) (West 1995). A dissolution is a fundamental transaction under the Protocol, involving the transfer of charitable assets, and review by the Office of Attorney General would be required.

III. Practical aspects.

A. When is notice to the Attorney General about the transaction required under the Protocol? The Protocol states that the parties to the transaction are required to provide written notice of the transaction to the Attorney General at least ninety (90) days prior to the contemplated date of the consummation of the transaction. The Attorney General must be given sufficient time from receipt of the written notice to review and evaluate the proposed transaction. For complex or controversial transactions, it may be prudent to provide the Attorney General with notice even earlier than required under the Protocol. In such cases, advance notice may be given to the Attorney General orally, followed at a later date by the required written notice.

1. What information is required to be submitted to the Attorney General along with the notice? The Protocol requires that the following information be provided at least ninety (90) days prior to the contemplated consummation date. Some information may not be relevant for a particular transaction.

- All information, including organic documents such as Articles of Incorporation, bylaws, endowment fund documentation, trust restrictions, expenditure history and other information necessary to define the trust upon which charitable assets are held.

- All complete transaction documents with attachments and including ancillary agreements involving officers, directors or employees.

- All documents signed by the principals or their agents which are necessary to determine the proposed transaction's effect, if any, on related or subsidiary business entities, whether nonprofit or for-profit.

- All financial information and organic documents regarding the post-transaction successor or resulting charitable entity, including all relevant information with respect to officers, directors, and employees (both current and post-transaction), in order for the Attorney General to determine independence, board composition, charitable purpose, and to review any financial arrangements with officers, directors, or employees which may be affected by the transaction, particularly those which have the potential of affecting an individual's objectivity in supporting or approving the transaction.

- All information necessary to evaluate the effects of the transaction on each component of an integrated delivery system, where transactions involve hospitals, including any changes in contracts between the integrated delivery system entities and related physician groups.

- All financial documents of the transaction parties and related entities, where applicable, including audited financial statements, any fiduciary accounts whether filed or not with Orphans Court, ownership records, business projection data, current capital asset valuation data, and any records upon which future earnings, existing asset values and fair market analysis can be based.

- All fairness opinions and independent valuation reports of the assets and liabilities of the parties, prepared on their behalf.

- All relevant contracts (assets and liabilities) which may affect value, including, but not limited to business contracts, employee contracts such as buy-out provisions, profit-sharing agreements, severance packages, etc.

- All information and/or representations disclosing related party transactions, which are necessary to assess whether or not the transaction is at arm's length or involves self-dealing.

- All documents relating to non-cash elements of the transaction, including pertinent valuations of securities for loans, stock restrictions, etc.

- All tax-related information, including the existence of tax free debt subject to redemption, disqualified person transactions yielding tax liability, etc.

- A listing of ongoing litigation, including full court captions, involving the transaction parties or their related entities, which may affect the interests of the parties or the valuation of charitable assets.

- All information in the possession of the transaction parties relative to the perspective of the nonprofit's beneficiary class or representative thereof (the community).

- All information, including internal and external reports and studies, bearing on the effect of the proposed transaction on the availability or accessibility of health care in the affected community.

- Organizational charts of the transaction parties, as they exist both pre and post transaction, detailing the relationship between the principal parties and any and all subsidiaries thereof.

2. The office of Attorney General may retain outside consultants and experts to evaluate the provided information or to gather additional information. In the event that such outside consultants or experts are retained, the costs for such persons shall be the responsibility of the parties requesting the transaction approval. The parties to the transaction may choose to allocate this cost in the transaction agreement.

3. Is the information provided to the Office of Attorney General kept confidential? The Protocol provides that no information provided to the Office of the Attorney General as part of the review will be privately or publicly disseminated concerning any transaction that is not objected to by the Attorney General unless dissemination is court ordered. Accordingly, in the event that the Attorney General objects to the proposed transaction or any portion thereof, the Attorney General may disclose information relating to such objections.

4. What happens after the Office of Attorney General receives the required information? The Attorney General may request further information regarding the proposed transaction. The Attorney General may schedule a meeting with counsel to the transaction parties to ask questions or state objections to the proposed transaction.

5. What role does the affected community or region play in the review process? The Protocol requires that reasonable public notice of the proposed transaction be provided by the parties to the affected community or region along with a reasonable and timely opportunity for the community to contribute to the deliberations of the parties and the Attorney General relative to the health care and charitable trust issues. To that end, the Office of Attorney General may hold a public hearing to discuss the proposed transaction. The following raises frequent considerations:

- What information about the proposed transaction should be given to the affected community?

- Who should assume responsibility for the dissemination of information to the affected community?

- How should public meetings and the dissemination of information to the affected community be addressed in confidentiality agreements?

- Should the parties to the transaction hold public meetings prior to the Attorney General public hearing?

- What role may the affected community play in shaping the structure and form of the transaction?

- How can challenges by community groups be avoided or mitigated?

6. What role does the Office of Attorney General play in structuring the actual terms of the transaction? Does the Office of Attorney General play a role in negotiating the transaction?

    - The role of the Office of Attorney General in an Orphans Court proceeding.

        - May support the transaction in Orphans Court.

        - May issue a letter indicating that it has no objection to the transaction.

        - May bring judicial proceedings to enjoin the consummation of any disputed transaction.

        - May seek to void any transaction consummated as being in violation of the law or contrary to public policy.

IV. <u>When are you required to go to Orphans Court?</u>

A. <u>Upon the direction of the Office of the Attorney General</u>.

The Protocol provides that if in the opinion of the Office of Attorney General the public interest would be best served, the Office of Attorney General may request that the parties to the transaction seek approval of the Orphans Court in the county of the nonprofit charitable corporation's registered office.

B. Transactions governed by 15 Pa. Cons. Stat. Ann. § 5547 (b) relating to the diversion of property committed to a charitable purpose.

C. How far does this really extend? Practically when do the parties actually go to Orphans Court? While there is no definitive answer to this question, the parties may go to Orphans Court with any of the following types of transactions:

- Sale of Assets?
- Mergers?
- Change of Control Transactions?

V. When does oversight of the transaction by the Office of Attorney General end?

A. Protocol.

Under the Protocol, the Office of Attorney General will maintain oversight of the transaction after its consummation to ensure that no subsequently executed contracts or arrangements between the parties or their agents effect a denigration of its terms. Additionally, this oversight might mandate that the resulting entity or surviving charity report on some ongoing basis to the Office of Attorney General to ensure that the terms of the transaction are fulfilled.

VI. Conclusion.

A. Attempt to involve the Office of Attorney General as early in the process as possible.

B. Work with your clients early in the process to begin gathering the necessary information for the Office of Attorney General's review.

C. If fairness reports and independent valuation reports have not been completed, the parties may choose to have them done early in the process. If not, the Office of Attorney General may require them at a later date. This could delay the approval process, and the cost for such reports may be higher.