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Lack of Oversight May Leave Operators Liable

Official Comm. of Unsecured Creditors v. Baldwin (In re Lemington Home for the Aged), 2011 WL 4375676 (3d Cir. Sept. 21, 2011)

In *Lemington*, the Third Circuit considered an appeal from the decision of the U.S. District Court for the Western District of Pennsylvania to enter summary judgment in favor of the directors and officers (D&Os) of a Pennsylvania nonprofit corporation on claims for breach of fiduciary duty and deepening insolvency. The court reversed, finding genuine issues of material fact as to whether the D&Os breached their duties of care and loyalty. The court also discussed the application of the business-judgment rule, the doctrine of *in pari delicto*, and deepening insolvency as a viable independent cause of action, each under Pennsylvania law.

The Lemington Home for the Aged was a Pennsylvania nonprofit corporation whose purpose was to provide elderly care. The home filed a Chapter 11 petition in the Western District of Pennsylvania in April 2005. For many years prior to its petition date, the home experienced financial and operating problems. These problems included inadequate operating revenue, excessive debt, poorly trained personnel, and inexperienced management. The home was insolvent by 1997 and growing concern warnings were issued in connection with the home's audits for fiscal years 2002 and 2003. In 2002, the home hired a new chief financial officer (CFO). However, the CFO failed to maintain a general ledger, and the home's financial and billing records were not maintained. In 2003, the home was cited for its failure to comply with record-keeping obligations. In 2004, the home's administrator informed the board that she would only work part time. At that time, the board did not act to keep the home in compliance with state law, which required the home to employ a full-time, licensed administrator. Also in 2004, the board was informed that the CFO was not maintaining appropriate financial records and that employee insurance premiums had not been paid, even though deductions had been made for that purpose. The board continued to employ and rely on the administrator and CFO.



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In July 2004, a patient died under circumstances that suggested neglect. Another patient died under similar circumstances in November 2004. On January 6, 2005, the home agreed to stop new admissions, which limited the home's potential sources of revenue. The board also considered options that included a potential merger and bankruptcy but did not authorize any action at that time. In March 2005, the board discussed plans to transfer the home's principal charitable asset to an entity with which the home shared an interlocking board of directors. As noted above, the home filed its Chapter 11 petition in April 2005.

The Official Committee of Unsecured Creditors filed an action against the home's D&Os in or about November 2005. On October 25, 2010, the district court granted summary judgment in favor of the D&Os on the committee's claims for breach of fiduciary duty and deepening insolvency. The district court held that the business-judgment rule and the doctrine of *in pari delicto* operated against the committee's fiduciary duty claims and that the committee had failed to demonstrate fraud, which is necessary to sustain a claim of deepening insolvency.

The Third Circuit reversed the district court. With regard to the committee's fiduciary duty-related claims, the Third Circuit noted that Pennsylvania law provides that a director of a nonprofit corporation stands as a fiduciary to the corporation and must perform his or her duties in good faith and that such a director may rely on officers and others whom the director reasonably believes to be reliable, provided that such a director does not have knowledge of information that would cause his reliance to be unwarranted. Here, the court found that the committee had adduced sufficient evidence to demonstrate a material question of fact with regard to both its duty of care and loyalty claims. With regard to the duty of loyalty, the court found that the board's consideration of a plan to transfer the home's significant charitable asset to a corporation with whom such board members were affiliated was sufficient to raise a factual issue for trial.

The Third Circuit also disagreed with the district court's conclusion that the business judgment rule and the *in pari delicto* doctrine applied to shield the D&Os from liability. With regard to the business-judgment rule, the court noted that Pennsylvania law provides that the rule may apply absent breach of fiduciary duty, lack of good faith, or self-dealing, and the rule assumes reasonable diligence. The district court had relied on evidence that the board was assisted by counsel, conducted several meetings, and considered options to bankruptcy in finding that the rule applied. The Third Circuit agreed that this type of evidence can support application of the business-judgment rule as a matter of law. Here, however, the board was aware of numerous problems—red flags—



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which compelled the Third Circuit's conclusion that judgment could not be entered as a matter of law.

For similar reasons, the court disagreed with the district court's application of the *in pari delicto* doctrine. While Pennsylvania supports that doctrine and the committee was exposed to its application, the Third Circuit noted that there is an exception where an agent acts in its own interest and not for the benefit of the corporation. Moreover, under Pennsylvania law, the underlying purpose of imputation includes fair risk-allocation, including appropriate protection for individuals who transact business with the corporation. Here, the Third Circuit found that evidence of the D&Os' potential self-interest—such as the board's discussion of a plan to transfer the home's principal charitable asset and the officers' interest in preserving their own employment—was sufficient to present a fact issue for trial as to whether the doctrine should apply to preclude the committee's claims.

Finally, the court considered the committee's claim for deepening insolvency. The committee based its claim on the board's decision to file the bankruptcy petition in April 2005, rather than January 2005. The Third Circuit recognized that Pennsylvania has not formally recognized such a claim and that courts and commentators increasingly have called into question the viability of a deepening insolvency claim. The Third Circuit noted, however, that it had previously recognized such a claim under Pennsylvania law and was bound by its own precedent in the absence of a contrary decision by an en banc panel of the Third Circuit. In light of the evidence of the D&Os' potential self-dealing and significant deficient operational decision-making, the court found a genuine issue of material fact as to whether the D&Os fraudulently contributed to the home's deepening insolvency in the subject period.

Keywords: litigation, bankruptcy, deepening insolvency, duty of care, duty of loyalty, *in pari delicto*

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