

Nursing Homes

**Court Upholds Verdict, \$2.25M in Damages
Against Bankrupt Elder Care Facility Officers**

Former officers and directors of a bankrupt nursing home properly were found liable for \$2.25 million in compensatory damages based on fiduciary duty breach claims brought by the unsecured creditors committee that represented the bankrupt home's estate, a federal appeals court ruled Jan. 26 (*Official Comm. of Unsecured Creditors ex rel. Estate of Lemington Home for the Aged v. Baldwin*, 2015 BL 16998, 3d Cir., No. 13-2707, 1/26/15).

The U.S. Court of Appeals for the Third Circuit found sufficient evidence that the officers and board members of the nonprofit health-care organization that operated Lemington Home for the Aged breached their duty of care and that the officers found liable after a jury trial also breached their duty of loyalty.

The committee also presented sufficient evidence to the jury to support its finding that the defendants breached their fiduciary duties by failing to exercise reasonable diligence and prudence in their oversight and management of the home as it slid toward bankruptcy in the early 2000s, the appeals court said.

The court found the evidence sufficient to support punitive damages awards—which totaled \$1.75 million—against the two officers but found the evidence was insufficient to support \$350,000 in punitive damages awarded by the jury against each of five of the 14 director defendants found liable for fiduciary duty breaches.

The latter awards were improper because the evidence didn't show the five directors engaged in a degree of "outrageous conduct" necessary to support a punitive damages award against them under Pennsylvania law, the appeals court said.

According to Michael W. Peregrine, with McDermott Will & Emery LLP, Chicago, the decision, which builds on the Third Circuit's September 2011 ruling in the case, provides important lessons for officers and directors charged with breaching their fiduciary obligations to, and exacerbating the financial condition of, a struggling nonprofit health-care provider.

Appeal Planned. Michael J. Bowe, who represented the officers and directors in the case, said that although he was pleased that the punitive damage awards were

vacated, he was disappointed that the court held it couldn't address the very substantial deepening insolvency issues raised in the case, except on an en banc basis.

The court declined to revisit whether deepening insolvency is a valid tort, relying on a prior three-judge panel's decision in *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340 (3d Cir. 2001) as binding authority in the Third Circuit.

"This court has now invited en banc review twice and we intend to seek such review on the remaining awards," Bowe said. He is with Kasowitz, Benson, Torres & Friedman LLP, New York.

According to Peregrine, "the *Lemington Home* saga provides one of the most consequential fiduciary duty lessons for nonprofit health care directors in recent years—especially for officers and directors of financially distressed organizations." The Third Circuit's latest decision "clarifies the extraordinary standards under which punitive damages can be awarded against directors," he added.

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—MICHAEL W. PEREGRINE,
MCDERMOTT WILL & EMERY LLP, CHICAGO

"While the good news is that, in this instance, the court overturned the award of punitive damages against the individual directors, the underlying breach of the duty of care and 'deepening insolvency' rulings against those officers and directors were upheld," he said.

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Community Asset Lost. According to the appeals court, the home was originally formed to help the disadvantaged and elderly black community at one location in 1883 and was relocated to another Pittsburgh site 100 years later. The court said the home faced challenges and encountered financial problems that spiraled between the time it was relocated and expanded and the time it closed in 2005.

The court cited in particular the actions of Melody L. Causey, hired as the home's administrator in 1997, and James Shealey, who became the home's chief financial officer in December 2002. The court cited evidence that, despite warning signs from the home's auditors, and two resident deaths that were blamed on neglect, the two officers and the home's board failed to ensure the home was properly managed.

The court specifically noted that the home lacked a treasurer and finance committee for several years and that no financial records were maintained. In addition, Causey was on an extended leave of absence because of a medical condition, yet she wasn't replaced, despite a requirement that the home have a full-time administrator, the court said. Causey also continued to draw full pay during this time, even though she conceded that she worked only part time, the court added.

At the time of the resident deaths, the court noted that the evidence showed that the home's board wasn't functioning properly; that minutes from board meetings weren't complete or properly maintained; and that the board's finance committee was defunct because the board lacked a treasurer. Instead, the board relied on the financial advice of Shealey, even though the board's chairman, Arthur Baldwin, stated that the board was aware as early as December 2004 that Shealey wasn't maintaining financial records.

The appeals court in its September 2011 ruling reinstated claims brought by the committee after they had been dismissed by a federal trial court. The trial court erred in granting summary judgment in favor of the officers and board members because there were sufficient facts to suggest the individuals may have breached their fiduciary duties (20 HLR 1456, 9/29/11).

The jury trial was conducted on remand.

'Heads in the Sand.' The appeals court determined that the two officers and 14 directors failed to satisfy fiduciary duty standards applicable under state law to individuals serving in their respective capacities. The evidence supported the jury's conclusion that Causey and Shealey failed to act diligently—breaching their duty of care—and acted to serve their self interests, which violated their duty of loyalty to the home.

The evidence also supported a finding that the directors breached their duty of care because they failed to take action to remove Causey and Shealey after they became aware that they were mismanaging the home.

"This evidence supported the jury's finding that the Director Defendants did not exercise reasonable prudence and care in continuing to employ Causey and Shealey" and "stuck their heads in the sand in the face of repeated signs that residents were receiving care that was severely deficient," the court said.

It reached a similar conclusion with respect to allegations that the directors contributed to the home's deepening insolvency by failing to declare bankruptcy sooner; failing to recover Medicare reimbursement to which it was entitled; and allowing the home's assets and resident base to dissipate while it continued to incur debt. The directors also mismanaged information and income that could have made the home a more attractive target for purchase, the court said.

The court concluded by upholding the punitive damages awards—\$1 million against Causey and \$750,000 against Shealey—after finding their mismanagement, malfeasance and self-dealing rose to a level that supported the awards. The court also found there was no state law requirement that the jury consider evidence of the defendants' ability to pay punitive damages before imposing them.

The evidence presented against the five directors, however, failed to show they acted outrageously or with a level of malice required to support the punitive damages awarded against them, the court concluded.

Bowe and Jennifer S. Recine, Kasowitz, Benson, Torres & Friedman LLP, New York; John R. Gotaskie Jr., Fox Rothschild LLP, Pittsburgh; and Mark R. Hamilton, Rebecca S. Izsak and Philip J. Sbrolla, Cipriani & Werner PC, Pittsburgh, represented the appellants. Robert S. Bernstein, Kirk B. Burkley, Nicholas D. Krawec, Shawn P. McClure and Arthur W. Zamosky, Bernstein-Burkley PC, Pittsburgh, represented the unsecured creditors committee.

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The court's decision is available at http://www.bloomberglaw.com/public/document/Official_Comm_of_Unsecured_Creditors_ex_rel_Estate_of_Lemington_H.

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