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# NEW RISKS FOR HOSPITAL BOARDS:
## *Good Faith Decisions with Bad Outcomes*

The public's confidence in the integrity of charitable organizations seems to be eroding at a rapid pace. The general governance and stewardship of resources of nonprofits is called into question every day, resulting in an increased emphasis on the basic fiduciary duties owed by each member of the nonprofit board, particularly the duty of obedience.

Many of you have been there: As CEO of your organization, you have presented a critical issue to your board. You've engaged outside consultants and provided all of the information the board needs to make an informed decision. You've checked potential conflicts and satisfied the procedural requirements to help ensure that the board's decision can withstand legal challenges. For all of your effort, you and the organization should be able to rely on the board's decision, right? Not necessarily. There is still something you should take into consideration: the duty of obedience.

In short, the duty of obedience tests the substantive, as opposed to the procedural, quality of decisions by nonprofit boards. Today, it is not enough that a board follows the proper procedures in making a decision. The decision itself must further the charitable purposes of the organization and do so in compliance with applicable law. In most states, a board member or the state attorney general has standing to sue the organization to enjoin an act tainted by an alleged breach of the duty of obedience. Moreover, the organization itself (directly, derivatively or through a receiver) has standing to sue a current or former board member for damages it incurred as a result of an alleged breach of the duty.

The duty of obedience is not new; it has long been used to measure the propriety of decision making by nonprofit boards. However, more emphasis has been placed on "how" board decisions were made rather than on "what" decisions were made. (The "how" of nonprofit boards' decision making, like their for-profit counterparts, has been governed by the duties of care and loyalty.) But satisfaction of the duties of care and loyalty does not always prevent decisions with disastrous consequences. In the for-profit world, government enforcement agencies, the courts and aggrieved individuals must search for remedies to bad board decisions outside the sphere of corporate governance law, which generally protects even bad board decisions found to be made in good faith. In the nonprofit world, the duty of obedience holds the board accountable for bad outcomes.

The duty of obedience is a legacy of charitable trust law, in which a trustee's primary duty is to strictly comply with the express terms of the trust. In broadest terms, it requires a nonprofit board member to understand the charitable mission of the organization and to ensure that the organization acts in furtherance of its charitable purposes and in compliance with applicable law and internal organizational policies. The key question in duty of obedience cases is whether the decisions and actions of nonprofit boards were within their power and furthered the charitable purposes of the organization, despite satisfaction of the duties of care and loyalty, and application of the business judgment rule.

A recent decision of the Supreme Court of Georgia demonstrates how the duty of obedience can be applied to reverse an otherwise properly made board decision. In *Shorter College v. Baptist Convention of Georgia*, the plaintiff was on the verge of losing its college accreditation because of interference in its operations, and the influence exerted, by the Baptist Convention of Georgia, the sole corporate member of the college. Although the members of the Shorter College board were appointed by the Baptist Convention, they rationally believed that the control being exerted by the Baptist Convention threatened the very existence of the college. The Shorter board created a new nonprofit corporation whose mission it was to operate a college. Then it voted to dissolve Shorter College and transfer all of its assets to the new corporation. The Baptist Convention sued the board, claiming that the board did not have the power to take such action without its consent.

The Supreme Court of Georgia first found that the Shorter board had satisfied its duty of care in making an informed decision with the rational belief that it was in the best interests of the college to maintain accreditation. The Court also found that the Shorter board satisfied its duty of obedience in two respects. First, insofar as the mission of the college was to operate an institution of higher learning and loss of accreditation would severely hamper its ability to do so, the dissolution and transfer were in furtherance of that mission. Second, notwithstanding the protestations of the Baptist Convention, the Shorter board, once appointed, was an independent body and had the power to act without the consent of the Baptist Convention.

However, the Court also found that, in one respect, the Shorter board had breached its duty of obedience. Under Georgia law, as interpreted by the Court, a nonprofit may dissolve and transfer its assets only to an existing corporation in the same general business. Because the Shorter board had transferred the college assets to a new corporation, its action was not in compliance with applicable law. The Baptist Convention won.

Will your board's decision withstand a legal challenge? Yes, if, in addition to satisfying the procedural decision-making requirements, your organization has the power to act in accordance with the board's decision and the outcome of that decision furthers the charitable purposes of the organization.

*If you have a question on this material, or would like to discuss legal services, please contact us at healthcare@duanemorris.com.*

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