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Candidate can't overturn election without showing damages

A candidate for director of the nonprofit Cairn Terrier Club of America could not overturn the club's election results when she did not specifically claim that the club's failure to follow its bylaw procedures cost her votes. The Commonwealth Court of Pennsylvania has affirmed a trial court decision dismissing her case.

The club's bylaws provide that nominees for director will be listed in alphabetical order, along with the names of the states in which they reside. The bylaws also say that following the procedures "exactly" is imperative if the membership is to maintain confidence in its system.

In the 2015 election, Ilene Kaplan and other candidates for director was listed with their identification by region, not by state. She and another candidate were the only ones listed as being from the same region. The ballot did not contain a statement that voters could elect more than one candidate from a region. She narrowly lost the election and complained that it was because of the confusion caused by the improper inclusion of regions on the ballot. She sued for breach of fiduciary duty and beach of contract for failing to follow the bylaws. The parties filed cross motions for summary judgment.

The trial court dismissed Kaplan's motion on the ground that the business judgment rule protects the directors and officers from liability when they make a decision in good faith and when they believe the decision is in the best interests of the corporation. The court found that the business judgment rule applied, and further held that the rule prohibited the court from further examining the merits of the underlying business decision. It denied Kaplan's motion for summary judgment and granted the club's motion for summary judgment.

On appeal, the Commonwealth Court said the business judgment rule was "irrelevant" to the decision of the trial court dismissing Kaplan's motion for summary judgment, but said that it had to determine whether there was any material issue of fact outstanding on which to deny a summary judgment for the club. Kaplan herself had admitted that there were no issues of material fact outstanding.

The Commonwealth Court accepted the trial court's statement that the factors necessary for a breach of fiduciary duty are: (1) the defendant's negligent or intentional failure to act in good faith and for the benefit of the plaintiff; (2) the plaintiff's injury; and (3) evidence

that the plaintiff's injuries resulted from the defendant's misconduct. A similar three-part showing was required for breach of contract, the trial court said.

The trial court had found that Kaplan failed to establish that any member of the club did not vote for her because of the confusing ballot. Since she failed to meet the third requirement for either claim, the trial court said, it denied Kaplan's motion and granted the club's motion for summary judgment.

Saying it could affirm a trial court decision on grounds different from those relied upon by the trial court where other grounds exist, the Commonwealth Court found that the trial court's reasons for granting the club's motion also support the denial of Kaplan's motion and it affirmed both decisions. (*Kaplan v. The Cairn Terrier Club of America*, Commonwealth Ct., PA, No. 218 C.D. 2017, 6/26/17.)

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Foundation Liable for Punitive Damages In Receiving Gift Induced by Fraud

Board member induced bank employee to invest in his bank and then transferred the same amount from bank to foundation

James M. Montgomery convinced an employee of a bank he was about to open to invest $100,000 in the business, saying he needed the additional money to meet regulators' capitalization requirements to start operating. Shortly after the employee made the investment in 2008 and before the bank opened for business, Montgomery directed the bank to transfer $100,000 to his family foundation. The bank failed in less than a year and all of the initial investors, including the employee, lost their investments.

The employee sued Montgomery and the foundation for fraud, on the theory that Montgomery induced him to make the investment by intentionally misrepresenting the bank's need for the money. The trial court entered judgment for the employee, awarding him $100,000 in compensatory damages, pre-judgment interest of $70,000 and punitive damages, against the foundation only, of $260,000. An appellate court in California has affirmed.

To show fraud, the appellate court said, the plaintiff must show that the defendant made a false representation as to a material fact; the defendant knew it was false; the defendant intended to deceive the plaintiff; the plaintiff justifiably relied on the misrepresentation; and the plaintiff suffered damages.

The trial court found that the employee made the investment in reliance on Montgomery's representation that it was necessary to open for business. It found that the representation was false because $100,000 was transferred from the bank to the foundation before the bank opened for business. It also found that the employee's reliance was justified because Montgomery knew more about the requirements than the employee did.

The appellate court said there was substantial evidence to support these findings. And it found that the trial court could reasonably have concluded that the employee would not have made the investment, as he testified, without the misrepresentation by Montgomery.

The foundation argued that the punitive damage award should be reversed because it violates public policy and had no evidentiary support. The Court was "not persuaded."

Fraud alone is an adequate ground for awarding punitive damages, it said. And it said that the punitive damages did not violate public policy because they are not intended to compensate the injured party but to punish and to deter the defendant and others from similar extreme conduct in the future. The foundation argued that it would have no deterrent effect because Montgomery had died before the trial.

But the Court said that "the foundation board exercised no oversight of Jim Montgomery. Every member of the board was also a member of the Montgomery family. The board met annually, to review donations being made by the foundation and its investment activities. Board members did not inquire about or review other deposits made into the foundation's accounts, nor did the board review the foundation's ledgers or general accounting. In general, board members trusted foundation officers to do their jobs. John G. Montgomery, Jim's son, testified he was not aware that $100,000 had been transferred from the bank to the foundation and was never asked to approve it. Andrew Montgomery, John's brother, confirmed the board did not discuss the transfer until [the employee's] lawsuit was filed, almost four years after the transfer occurred."

The Court said that the members of the board "exercised no oversight" over Montgomery and "took no action to discover the transfer or inquire about the foundation's ultimate use of those funds," which "constitutes substantial evidence supporting the award of punitive damages against the foundation." (*Sterling v. Montgomery*, Ct. of App., Second Dist., Div. 6, CA, No. B267038, 7/25/17.)

YOU NEED TO KNOW

This is a highly unusual case. The Court blamed the board of the foundation for a total lack of oversight over one of its directors and found justification for punitive damages, a rarely invoked penalty for egregious action. Meeting only once a year, as this foundation board did at the time, is itself almost an admission of failure to exercise appropriate fiduciary duty. Even where everybody is a member of the family, as was the case here, it is not a good idea.

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PSU Trustees May Recover Costs Of Suit for Right to Review Records

Recovery permitted by expense reimbursement policy and indemnification clause in bylaws

Alumni trustees of Penn State University may recover the litigation costs of their successful suit to gain access to “source materials” of the Freeh Report on the Jerry Sandusky situation, the Pennsylvania Commonwealth Court has held.

Reversing a trial court, two of the three judges on the three-judge panel decided that the University had to pay the costs under the University’s cost reimbursement policy set forth in its corporate charter. All three judges said payment was required under the indemnification clause in the bylaws. And they all agreed that they didn’t have to decide whether payment was required under the state’s nonprofit corporation law.

Eight alumni-elected trustees had sued to obtain access to the backup materials for the report that former FBI chief Louis J. Freeh had issued on the handling of sexual misconduct charges against former assistant football coach Jerry Sandusky. They argued that they needed the information in order to fulfill their fiduciary duty to the University in connection with pending litigation and other matters. A majority of the board of trustees had said they did not need the information. A trial court in Center County had ordered the University to provide access, subject to certain confidentiality requirements agreed to by the trustees. The University did not appeal. (See *Nonprofit Issues*®, 9/15.)

The University’s charter provides that trustees will serve as volunteers and shall not be compensated for their services. But it adds that they may be “reimbursed upon request for transportation and other direct expenses while engaged in the discharge of their official duties, in accordance with the University’s travel reimbursement policies in effect from time to time.”

The trial court had held that because the charter specifies that reimbursement will be made in accordance with the University’s travel reimbursement policies, litigation expenses were not covered. The Commonwealth Court disagreed.

“If the Corporate Charter limits a trustee’s reimbursement to travel expenses alone, then the phrase ‘other direct expenses while engaged in the discharge of their official duties’ is surplusage and has no meaning. The travel policy, which changes from time to time at the

pleasure of the University's management, is not dispositive," the Court said. "Indeed, a policy adopted by the corporation's management cannot be used to defeat the terms of a corporate charter. Trustees are volunteers, but they are not expected to personally fund their expenses in providing their services. Otherwise, only persons of financial means would be able to serve as trustees."

The dissenting judge concluded that the corporate charter was actually silent on this issue and did not concur with the majority's finding.

The University's bylaws provide that a trustee "shall be entitled as of right to be indemnified by the University against expenses and any liability paid or incurred by such person (i) in the defense of any Action to which such person is a party or (ii) in connection with any other Action." It defines "action" as any action, suit or proceeding, administrative, investigative or other to which such person is a party (other than an action by the University). It further says that expenses shall include fees and expenses of counsel incurred by the indemnitee if the University has not provided a defense.

The University argued that indemnification was limited to actions in which the trustee was a defendant. But the full Court said the bylaws provided for payment of fees "in connection with any other Action."

The University also relied on the University president's statement that the University did not have to pay for "frivolous and damaging" lawsuits. The Court said the statements did not override the bylaws and the fact that the trustees had prevailed showed the suit was not frivolous.

Having decided for the trustees on the basis of the corporate documents, the Court did not reach the trustees' argument that they were entitled to fees under the state nonprofit corporation law. The Court said the statutory provision granting such payment was cross-referenced to a provision providing counsel fees as a sanction against "dilatory, obdurate or vexatious conduct." To reach a conclusion providing the trustees with their expenses, the Court did not have to decide whether the University's conduct met this standard.

The Court remanded the case to the trial court for a calculation of the fees to which the trustees are entitled. (*In Re: Application by Nonprofit Corporation Trustees to Compel Inspection of Corporate Information*, Commonwealth Court, PA, No. 721 C.D. 2016, 3/13/17.)

YOU NEED TO KNOW

This decision is based on the specific language of internal corporate documents, rather than the general provision of state law that would have more general applicability. Trustees seeking reimbursement should look carefully at the specific language of their corporate policies, which may be susceptible to broader reading than may first appear.

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Receiver May Claim Under D & O Policy For Alleged Breach of Duty by Directors

Court says claim is not excluded under insured-versus-insured exclusion

A court appointed receiver for a nonprofit community action program may claim breach of duty by two former officers and demand that the organization's D & O insurance carrier make payment. A federal District Court in Rhode Island, reviewing conflicting cases in other jurisdictions, has held that the claim is not excluded by the "insured-versus-insured" exception contained in the policy.

The Providence Community Action Program purchased a directors and officers liability policy entitled "Flexi Plus Five" in 2011 from the Philadelphia Indemnity Insurance Company. Shortly thereafter, the organization experienced financial difficulty and was forced into receivership. Its certificate of authority to conduct business was subsequently revoked.

The receiver brought a breach of fiduciary duty claim against two former officers and sent a demand letter to the carrier. The carrier denied the claim, saying it did not cover claims brought by the receiver "on behalf of" the organization against officers who were also named insureds under the policy.

The Court said the question depended on "the role of the receiver under Rhode Island law." The carrier argued that he was bringing an action "on behalf of" the organization. The receiver argued that he acted on behalf of the state court that had appointed him.

The parties cited a number of cases in other jurisdictions that had resulted in conflicting decisions, the Court said. There was no controlling law in the First Circuit or the state Supreme Court.

But when a court orders a company into receivership in Rhode Island, the Court said, the receiver, as an officer of the court, takes possession of the company in custodia legis. It divests the debtor of legal title and leaves the organization with only a contingent right to the property. The receiver is empowered to distribute the property to various interests as the receiver and the court deem appropriate.

Citing a series of cases and academic articles, the Court found that "a Rhode Island receiver is not accurately described as working 'on behalf of' the pre-receivership entity. Instead, a Rhode Island receiver is better understood as an agent of the Superior Court that appointed

the receiver and as working for the potential benefit of various parties." It held that the insured-versus-insured exception did not apply.

The Court also rejected an argument by the carrier that an amendment to the policy after the appointment of the receiver characterized the actions of the receiver as actions on behalf of the organization. The parties did not have the authority to alter the relationship by contract when the receiver had the statutory authority and duty to act on behalf of the court, it said. (*Philadelphia Indemnity Insurance Company v. Providence Community Action Program*, D. RI, C.A. No. 15-388, 1/24/17.)

YOU NEED TO KNOW

The insured-versus-insured exclusion often vitiates coverage under D & O policies in critical situations. This exception, based on state law that is apparently not the same in all states, is an important one to remember when the situation becomes so bad that a receiver or bankruptcy trustee is appointed.

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Mastercard may limit contribution to charity

From 2011 to 2015, Mastercard International advertised nationally that it would donate a penny to Stand Up to Cancer for each credit or debit card transaction of at least $10 in a U.S. restaurant, up to a specified end date or whenever Mastercard reached its $4 million maximum donation limit.

Robert Doyle, a New Jersey resident who used his Mastercard at restaurants in Florida and New Jersey during these years, sued Mastercard for breach of contract because it continued to advertise its contribution even after it became apparent that the $4 million minimum had been reached. He also claimed a breach of implied covenant of good faith and fair dealing and a separate violation of the District of Columbia Consumer Protection Procedures Act. He sought certification of the case as a class action.

A trial court in Manhattan dismissed the case. The Second Circuit Court of Appeals has affirmed.

Under New York law, the Court said, where the terms of the Mastercard advertisements were "clear, definite and explicit," as Doyle acknowledged, "regardless of when the advertisements appeared or how certain Mastercard was that the maximum donation would be met, there was no breach of contract." It also ruled that New York law does not recognize a separate cause of action for breach of an implied covenant of good faith and fair dealing when a breach of contract case based on the same facts is also alleged.

The Court affirmed the failure to certify the case as a class action because Doyle had not claimed that he was personally injured by Mastercard's actions. And it dismissed the consumer protection claim, again for lack of standing, because he failed to claim a personal injury under the District of Columbia or any other consumer protection action. (*Doyle v. Mastercard International*, 2nd Cir., No. 6-4270, 7/6/17.)

You Need to Know…. It is aggravating when a company continues to advertise a promotion such as this when you know — or at least have a serious suspicion — that the limit has already been reached. At least one major charitable solicitation registration case was decided against the advertiser when the limit was not clear and it could be inferred that every purchase would create an additional contribution for the charity. But where the limit is clear, at least according to New York law and this case, the purchaser has no recourse, despite the sour taste it may leave after the restaurant meal.