

New Development Regarding Director Liability

Michael W. Peregrine, Esquire

McDermott Will & Emery LLP
Chicago, IL

Elizabeth M. Mills, Esquire

Proskauer Rose LLP
Chicago, IL

A recent U.S. Court of Appeals decision provides guidance on the liability profile of a nonprofit board member who becomes involved in the day-to-day operations of the organization. On February 26, 2009, in *Verret v. U.S.*, the Fifth Circuit affirmed the district court's summary judgment decision against a hospital board chair who had been assessed a \$408,918.66 penalty by the Internal Revenue Service (IRS) for unpaid organizational payroll and related taxes. The *Verret* decision is important because it addresses the risks that arise when the distinction between governance and management is blurred, and from director-as-vendor arrangements. It also serves to emphasize the importance of board oversight of organizational tax obligations, particularly in stressful economic times. Accordingly, nonprofit corporate counsel may wish to advise board and executive leadership of the implications of this decision.

General Rule

Employers, including tax-exempt employers, are obligated under the tax code to withhold income tax and Social Security and Medicare taxes from their employees' wages, and to turn over all withheld taxes to the government within prescribed time frames. The withheld amounts are called "trust funds" because they are held in trust for the government. Employers are also obligated to pay the employer's share of Social

Security and Medicare taxes. In financially troubled times, an employer may be tempted to use the money it has withheld from employees' wages to satisfy other liabilities that appear more pressing. Likewise, an employer may fall behind on paying the employer's share of Social Security and Medicare taxes.

Not surprisingly, the IRS has at its disposal a variety of ways to collect these taxes and punish those who do not pay the government what is owed. Most of these penalties are imposed on the employing organization. However, individuals who are the employer's "responsible persons" can be held personally liable for willful failure to withhold from employees' pay or to pay over-withheld taxes. The penalty imposed is the entire amount of the funds not paid to the government—potentially a very large amount. This can be imposed on an individual who has the effective power to pay or not pay the taxes. Code Section 6672(e) does provide for an exception to the "trust fund penalty" for voluntary board members of tax-exempt organizations. That exception does not apply, however, when the board members participate in the day-to-day financial operations of the organization or have actual knowledge of the failure on which such penalty is imposed.

Core Facts

At issue was whether the board chair of a tax-exempt, nonprofit hospital should be considered a "responsible person" for the hospital's failure to pay over income and withheld (Social Security and Medicare) taxes for hospital employees. The board chair and other directors served on a voluntary basis, and the hospital employed a full-time executive director and controller/chief executive officer. During the three-year period of his chairmanship (he served for a total of twenty-six years on the board), the hospital was in substantial financial stress and had been frequently delinquent in the payment of its employment taxes. After the initial delinquency, the board monitored the payroll tax payment issue and requested that the executive director take steps to assure timely payment in the future. The board repeatedly monitored the executive director in this regard. Subsequently, the board was informed that the hospital again was delinquent on payroll taxes, but the record did not reflect that the board took action other than urging the executive director to make payment. The board continued to rely on the executive director in this regard even after a decision was made to replace him and a search was

commenced for his replacement. Ultimately, the IRS found the board chair, executive director, and controller to be responsible parties for the payment of payroll taxes. The executive director settled with the IRS, while the board chair paid the \$408,000 penalty and instituted the civil action to recover the payment.

The Resolution

On February 26, the Fifth Circuit affirmed a 2008 decision of the U.S. District Court for the Eastern District of Texas upholding the IRS' imposition of these penalties on the board chair. Like many other circuits, the Fifth Circuit has established its own indicators of responsibility that connote authority with respect to withholding or employment taxes. These indicators are intentionally broad—to encourage officers, directors, and employees to be mindful of corporate payroll tax withholding obligations. The indicators disregard mechanical titles and functions and focus instead on those individuals who could actually assure the satisfaction of the tax obligations.

Given that, the district court had placed little weight on the voluntary nature of the chair's board service, and placed substantial weight on the extensive administrative duties that had been assumed by the board chair. Critical factors supporting the court's conclusion that the board chair was a "responsible person" included that he had: (a) served on the board for twenty-six years; (b) signed the Form 990s for multiple years; (c) been a signatory on hospital accounts; (d) been a vendor to the corporation; (e) personally guaranteed a loan to the hospital; and (f) otherwise been personally involved in hospital matters, including tax matters. The court also concluded that he had acted willfully in that he ignored unpaid taxes of which he was aware or with respect to which he had a duty to investigate. In reaching that conclusion, the court rejected on the basis of the overall factual record the argument that the board chair had reasonably inferred that the tax situation had been corrected. This argument was rejected because the record reflected substantial evidence that the board chair was in substantial contact with the CEO, spent considerable time at the hospital, and was aware of the hospital's deteriorating financial condition. Further, the Sec. 6672(e) voluntary board member exception was determined not to apply because the board chair was not serving solely in a voluntary/honorary position. Thus, while volunteer directors and officers of tax-

exempt organizations are usually thought of as being beyond the responsible person penalty's reach, circumstances may dictate otherwise.

Analysis

The *Verret* decision is relevant beyond its core because it addresses issues of board liability at a time when significant questions are being raised about the proper scope of board oversight of operational issues. Directors are generally sensitive as to their liability profile given the current level of economic stress. A leading credit rating agency has commented favorably on the benefits of decisive action by the board (in conjunction with management) to identify looming financial problems and implement immediate corrective strategies. Indeed, some leading (non-lawyer) governance consultants are recommending that the board intensify the level of involvement in operations and management far beyond traditional board management boundaries. In that context, *Verret* takes on particular significance:

1. It is not as dire a result as some board members are interpreting it to be; it's not evidence of a greater willingness to assess operational liability against board members. Clearly, the board chair had a most unusual level of involvement with the hospital that made it relatively easy for the court to disregard his volunteer status.
2. Nevertheless, it is a stark reminder of the liabilities that can be visited upon board members who actively and extensively participate in an executive capacity, or who act as significant vendors to the corporation. Indeed, we don't know whether any one of the many executive or vendor or other non-governance relationships would have been sufficient on its own for the court to apply "responsible person" status. Further, the broad judicial interpretation of who can be a "responsible person" for tax penalty purposes could conceivably be adopted for purposes of other claims for director liability.
3. It is a strong reminder of the board's need to assure satisfaction of organizational obligations for payroll and related taxes, particularly given difficult economic times. Notably, the *Verret* court did not find that the series of directions and inquiries by the hospital board were sufficient to address its

obligations to ensure payment of the taxes. Further, the standard delegation of management duties provision in the corporate bylaws was applied by the court to counter the chair's argument that he was not a responsible person.

There is a certain unavoidable tension between the desire to reduce one's individual liability profile, and the obligation to exercise effective oversight of financial and tax matters. Corporate counsel are thus encouraged to discuss with executive and board leadership the ramifications of the *Verret* decision, and to help the board appropriately balance financial and tax oversight obligations with the risks associated with increased involvement in management affairs.

Verret v. U.S., 103 AFTR 2d 2009-1189 (Feb. 26, 2009).

New Development Regarding Director Liability © 2009 is published by the American Health Lawyers Association. All rights reserved. No part of this publication may be reproduced in any form except by prior written permission from the publisher. Printed in the United States of America.

Any views or advice offered in this publication are those of its authors and should not be construed as the position of the American Health Lawyers Association.

"This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is provided with the understanding that the publisher is not engaged in rendering legal or other professional services. If legal advice or other expert assistance is required, the services of a competent professional person should be sought"—*from a declaration of the American Bar Association*