NON PROFIT CORPORATIONS

AND

THE DECISION TO LITIGATE

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This Article reviews the step-by-step process that Boards of Directors of nonprofit organizations should take in deciding whether to initiate litigation. Condominium and townhome organizations are generally formed as nonprofit corporations under 765 ILCS 605/1 and 805 ILCS 105 et. seq. Charitable organizations (Colleges, hospitals, foundations, and other 501c3 identified groups) are also nonprofit organizations. Attorneys who advise either group, along with their Boards of Directors often confront one of two dilemmas: either defending a lawsuit, brought against the organization, or initiating a lawsuit to collect assessments, recover funds, enforce rules, cure construction defects to their property, resolve charitable conflicts of interest, or resolve fiduciary issues.

Defending most cases simply, and often, involves turning over the defense to the insurance company of the Association which will either defend, defend under a reservation of rights, or decline coverage. In the latter two instances, counsel should be involved to protect the rights of the Board, often by filing a declaratory action against the insurance company to determine coverage.
On the other hand, initiating litigation by any non profit involves a much more complex review, with counsel, of the points noted below, presented here as a narrative checklist.

AUTHORITY:

1. Incorporation/ Good Standing

    a. Is the Association actually incorporated? When a developer of property records Declarations and Covenants, those documents contain language establishing a Board of Directors to manage and maintain the common elements (streets, pools, landscaping, etc.). A simple check of the Secretary of State web site at www.sos.state.il.us will provide both the incorporation data, as well as whether the Board is currently in good standing (by payment of the annual franchise fee)along with a guide for organizing the non profit corporation. While the Guide provides

much of the information necessary to incorporate the organization, counsel should be consulted since by-laws and local Rules may play an important role in governance issues.

b. Is the Association in "good standing"? It goes without saying that initiation of litigation requires both incorporation, and meeting the "good standing" requirement. Failure of a Board to maintain itself in good standing by filing the required annual report with the Secretary of State will result in the State involuntarily dissolving the corporate entity...a rather embarrassing discovery by plaintiff's counsel. For that reason alone, the Board should maintain copies of the current annual report in its minutes/records.

2. Declarations/governing documents

a. The Board, and counsel, should review the recorded Declarations. The "definitions" section will identify the formal name of the Association, which will appear as plaintiff. Later sections in the declarations will, or may, discuss the prerequisites to litigation-most often the requirement of a vote. Some Developer-drafted declarations may require a vote of owners, other declarations simply a vote of the Board. The Illinois not for profit statute, at 805 ILCS 105/103 vests the Board with the authority to sue and be sued, along with a listing of other corporate powers necessary to effect the purposes of the organization. However, that statutory authority does not relieve the Board, and counsel, from following its own, recorded, declarations. Hence, as a part of the due diligence required of counsel, the threshold decision of whether to submit the issue of litigation to a vote must be determined and made a part of the Board's minutes from executive session.

b. Practically, submitting the issue to a vote (owner if required, otherwise certainly to the Board for its vote, is also an opportunity to both educate the owners about the substance of the matter(s) at issue, and to allow the owners to adopt a special assessment to fund the litigation.

c. Finally, on this point, the Board and counsel should also review the corporate by-laws, which are often recorded as a part of the Declarations and Covenants. The by-laws will contain the procedural method (percent of vote required, notice of meeting to adopt a special assessment to fund litigation, proxy requirements, etc.) by which the Board will meet its obligations under those governing documents in anticipation of the litigation to come.

3. Insurance

a. Does the Board maintain liability and/or Director and Officer Insurance? Is the policy current? While the plaintiff's decision to initiate litigation seldom triggers the notice requirements of insurance policies, it is a part of the Board's best practices to nevertheless review the policy. This will be particularly important in the event that the putative defendant files a counterclaim against the Board. It would be a fiduciary problem, to be charitable, to discover in that event that the insurance coverage had lapsed, or was inadequate.

b. As a more practical matter, the Board may want to invite the insurance agent for liability coverage to a meeting to discuss, in more general terms, enterprise risk management. This will involve a description of what is covered, what is excluded, and the claim-filing process.

4. Statutes of Limitation/Warranties/Legal Prohibition

a. One of the final threshold issues of "authority" relates to statutes of limitation and other legal prohibitions to filing suit. Each separate cause of action (construction, contract, tort, fiduciary, civil rights, etc.) will have a separate, unique period of limitation, beyond which an action cannot be brought. For example, if a construction case must be brought within four years, then 735 ILCS 5/13-214 (tolling the limitation until the discovery of the defect) may apply. Likewise, these statutory limitations on filing suit may be tolled until the unit owners gain control of the Board, 765 ILCS 605/18.2 and 765 ILCS 605/18.5 f 6.

b. Warranties, either expressly included in contract language, or implied by case law, may also proscribe an Association's ability to initiate litigation.

c. 735 ILCS 5/2-619 provides defense counsel with a list of legal bars to plaintiff's cause(s) of action, including jurisdiction, capacity, payment, etc. Counsel must rule out each of these defenses prior to initiating litigation as a part of his/her due diligence.

d. Even the Illinois nonprofit act itself insulates previous (and current) board members from suit, providing in part at 805 ILCS 105/107.85 (non liability for debts of the corporation), and 805 ILCS 105/108.70 (not liable for their judgment or conduct in the course of Board business). As a consequence, board members are immune from liability, and suit, unless they have acted in a "willful and wanton" manner; a very difficult standard to allege and prove.

e. Finally, even the recorded documents may, to some degree, relieve the developer of community association property, or current board members, from liability, providing release and indemnification language as a part of the governing documents.

COUNSEL:

1. Who's on the team? Successful litigation requires a team approach...consisting of competent counsel and witnesses (experts, board members, accountants, etc.), all pulling in the same direction. Assuming that all of the "Authority" issues previously raised have been satisfactorily resolved, the Board needs to be advised of the business aspects of the proposed litigation.

a. First among the issues, and on the top of every Board members mind, is the cost of proceeding. Attorney's fees may be hourly, and in major metropolitan areas currently average from $300 to more than $450/hr. Most private firms will provide

the Board with an engagement letter, specifically detailing the billing arrangement. On occasion firms will take cases on a contingent fee, taking 30-40% of any award as their fee. In the rare instance a firm will agree to a fixed fee, or will agree to "cap" its fees at a certain level. Again, the engagement letter will detail the arrangement, including potential costs (experts' fees, filing fees, travel, discovery expenses, etc.) which will be in addition to the attorney's fees.

b. Because of the vagaries of litigation, it is very unlikely that a firm can accurately estimate the total costs and fees. If a defendant is served and defaulted, the fees will be deminimus. If a protracted jury trial is required, the fees and costs could exceed six figures. Add to this, the possible cost of Appellate work, a separate fee altogether, and the Board should have a pretty good idea of what it is "buying into."

c. Identifying competent counsel is key to the process. There are, of course, Internet sites available, like Findlaw.com, etc.

d. One of the most accessible sources may by the county bar association lawyer referral service, listed locally under the county bar association.

e. Referrals from local law firms will also provide a reliable source of recommended firms/attorneys. A simple but business-like interview process is important, to determine the counsel's experience and references will provide a look into his/her expertise. Find out, for example, the case citations most recently tried, and call for references.

COST/BENEFIT ANALYSIS:

1. What is the likely cost of obtaining this benefit (judgment)?

   a. Balancing the attorney's fees and costs, identified above, with the eventual benefit of winning a recovery is difficult, but necessary for the fiduciary to determine and record in the corporate minutes, regardless of the decision of the Board. For example, lengthy construction litigation, tried to a jury, could well exceed six figures. On the other hand, if the expert's opinion of damages is in the millions, the cost of obtaining a judgment is diminimus in view of the potential recovery. The opposite, of course, holds true as well. Part of the balance sought by the Board, and counsel, will be the likelihood of a judgment—the first step to collecting and recovery. Counsel should be able to give a reliable opinion to the Board on the likelihood of obtaining a judgment. It will, of course, be derivative of the witnesses, documents, and quality of evidence for the Board's case and the available "defenses" if any, for the defendant.

   b. Once the quality of the case for the plaintiff, as well as the defense, is determined, the likelihood of actually collecting on the judgment must be analyzed...before the decision to litigate is made.

i. If, for example, the defendant files bankruptcy, or a lender forecloses on the defendant's real property assets, or the defendant is simply no longer in business, there may be little likelihood of actually getting paid. Often, plaintiff's counsel, as a part of his/her due diligence in advising the Board, will have investigated the financial viability of the defendant.

ii. Insurance may also be available from the defendant's carrier, depending upon the nature of the action brought by plaintiff.

iii. Often, the post-judgment collection proceedings will help determine where assets are located to satisfy the judgment. This is not, however, helpful in the initial decision to litigate, since no asset inquiry discovery can occur (short of a proceeding pre-judgment to attach assets if there's a sense that they may be removed from the jurisdiction of the court once the case is filed)prior to the initial filing.

iv. The most prudent course, therefore is to actively investigate the defendant's financial viability before deciding to litigate. Services are available for such investigation, as well as public sources (recorders offices, etc.).

c. Settlement should be explored by written demand upon the defendant. This needs to be a sincere, fully briefed (cases and facts) effort, within a specific time frame. Failure to make a good faith effort, prior to litigation, would probably be a tactical and political error, poorly serving the plaintiff. It may also be a violation of the Code of Professional Responsibility.

d. While at first blush, there appears to be no incentive for a defendant to "settle", there being no pending litigation, a persuasive brief in support of the plaintiff's theory of liability, and the likelihood of recovery, will both demonstrate to defendant the plaintiff's preparation and willingness to pursue the claims, and the common sense decision to limit the damages by an early settlement.

CAUSES OF ACTION: Listed below are a few of the categories of causes of action which various nonprofit organizations will be considering.

1. Condominium/townhomes

a. Construction defects(contract/ warranty/negligence/breach of industry standards)
b. Civil rights/fair housing(both federal and state-based statutes)
c. Breach of fiduciary(a hybrid tort action based in common law and statute)
d. Management/Agency(contract)
e. Collecting Assessments(statutory)
f. Bankruptcy/Foreclosure(both state and federal statutory actions)
g. Conflicts of interest(common law)

2. Charitable organizations (Title 26, 501c3, etc.)

    a. The defense of IRS/audit issues
    b. Initiating removal actions for conflicts of interest (board members)
    c. Vendor suits (collecting or defending contract actions)
    d. Employment contracts, discrimination, or other labor issues

A FINAL THOUGHT: Litigation also has intangible "costs", and Boards should address these realistically before proceeding to vote to initiate litigation:

1. There is an emotional, very personal investment by Board members who initiate litigation. On one hand, they're charged as fiduciaries to carefully manage other people's money, to further the organization's purpose. Along with that duty comes the responsibility to be informed, and business-like in the process. The time-consuming aspects of litigation simply cannot be avoided by board members, who may be called upon to find documents, give depositions, or testify at trial. There's also the pressure that comes from the organizations members (or dissenting board members) to limit the Board's role or costs.

2. Finally, the media will have access to all aspects of the public trial proceedings. Generally private condominium associations, and charitable organizations, may inevitably read about their "case" in the press. Part of the decision-making process turns on whether fund-raising would be affected, or a College's enrollment, or a condominium's value.

Respectfully Submitted, Jeffry J. Knuckles