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Corporate Governance

"Zone of Insolvency": Fiduciary Update For Healthcare Directors

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Directors of financially distressed hospitals and other healthcare companies received good news recently when the Tennessee Supreme Court held as a matter of law that creditors have no right to assert breach of fiduciary duty claims against the officers or directors of a corporation that is insolvent or in the "zone of insolvency." (*Sanford v. Waugh & Company, Inc. et al.*, 2010 Tenn. LEXIS 1151 (Tenn. Dec. 17, 2010)). The question of whether officers and directors of distressed companies owe separate fiduciary duties to corporate creditors has been the subject of much dispute for over the past 15 years. By its *Waugh* decision, the Tennessee Supreme Court joins a growing number of state and federal courts that have been persuaded by recent Delaware decisions to provide directors with greater protections and flexibility to deal with organizational financial distress. Collectively, these decisions will make it much more difficult for individual creditors, creditors' committees, and bankruptcy trustees to assert direct fiduciary duty claims against corporate officers and directors. Given the transitional state of the healthcare economy and of many healthcare providers, this growing trend of caselaw represents a positive governance development.

Background

As is well established under general corporate law principles, directors owe basic fiduciary duties of care and loyalty in discharging their responsibilities as board members. These duties are owed to the corporation and its shareholders (or, for nonprofits, to the corporation and its charitable mission). In other words, directors stand in a relationship of trust vis-à-vis the corporation they serve. The requisite "special trust and confidence" at the core of a fiduciary relationship exists between the individual board members and the organization and its owners or charitable mission, and not third parties. Significant confusion was added to the mix, however, with a 1991 decision issued by the Delaware Chancery Court in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 1991 Del. Ch. LEXIS 215, which suggested that directors may owe separate fiduciary duties to creditors when the corporation enters the "zone of insolvency" (i.e., is at the brink of insolvency). The decision was based on the presumption that as the corporation reaches the brink of insolvency, the equitable interest in the entity shifts from the shareholders to the creditors as residual beneficiaries of any increase in corporate value. By this logic, the fiduciary duties of the officers and directors should similarly shift from being owed to the corporation and its mission to being owed to the creditors. Without this shift, it was argued, the officers and directors would be motivated to pursue highly risky strategies in the interests of stockholders who have nothing to lose; the legitimate interest of creditors would be placed at risk.

Without guidance from the Delaware Supreme Court, substantial uncertainty reigned with respect to (a) the precise definition of "zone of insolvency"; (b) whether officers and directors of financially distressed companies would be exposed to liability to creditors for their business decisions, notwithstanding the principles of the business judgment rule; and (c) whether the duty-shifting zone of insolvency principles applied to nonprofit corporations, which by nature do not have equity ownership interests. For many years following the *Pathe* decision, aggressive bankruptcy trustees, creditors, and creditors' committees have pursued fiduciary duty claims for their own losses directly against officers and directors of financially distressed companies. A particularly aggressive variation of these claims, known as "deepening insolvency" claims, was based on allegations that the officer's or director's conduct materially exacerbated the insolvency of an organization. The healthcare sector was not immune to creditor pressures applying such claims.

Collectively, the onslaught of zone of insolvency claims and deepening insolvency claims had the effect of negatively influencing officer and director judgment by the threat of direct personal liability to creditors. This negative influence has been felt acutely in the healthcare sector in recent years, given the extraordinary financial challenges faced by hospitals and other providers (in particular, by providers in competitive markets who lack the ability to access capital and take advantage of economies of scale).

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Zone of insolvency-related fears create a significant distraction to the exercise of business judgment by the officers and directors of financially distressed organizations. Indeed, hospital bankruptcies regularly culminate in highly publicized litigation against officers and directors for breach of fiduciary duty. Such litigation certainly has had a "ripple effect" causing some officers and directors of distressed facilities to eschew risk in favor of self-preservation at precisely the time when the organization is in greatest need of involved and informed corporate governance and leadership.

The Tide Begins to Turn

Two fairly recent decisions issued by the Delaware Supreme Court are leading the trend against "zone of insolvency" liability principles. First, in May 2007, the Delaware Court held in *North American Catholic Programming Foundation v. Gheewalla*, *et al.*, 930 A.2d 92, that creditors do not have standing to assert direct claims (as opposed to derivative claims) for breach of fiduciary duty against directors, regardless of whether the corporation was during the relevant period of time insolvent or operating in the zone of insolvency. Three months later, in *Trenwick America Litigation Trust v. Billet, et al.*,[1] the Delaware Court refused to recognize a cause of action for "deepening insolvency" under state law. As in *Gheewalla*, the *Trenwick* court made clear that "the appropriate tool to examine the conduct of the directors is the traditional fiduciary duty rule."[2] While these two Delaware cases have enabled healthcare lawyers representing distressed companies to push back against creditor allegations of breach of fiduciary duty, they have not stopped such allegations from arising.

Tennessee

Waugh involved a garden-variety dispute between a corporate creditor seeking to enforce the terms of an installment stock sale agreement and his co-owners of a small enterprise. The company subsequently became insolvent, ceased performing under the terms of the agreement, and the creditor asserted a direct claim against the company's officers and directors for breach of fiduciary duty. The trial court dismissed the claim but the intermediate state court of appeals reversed, holding that a creditor of an insolvent corporation could indeed assert a direct, as opposed to derivative, claim against corporate officers and directors. The Tennessee Supreme Court reversed and expressly adopted the reasoning of the Delaware Supreme Court in *Gheewalla*. In doing so, the Tennessee court relied on the following two principles:

First, that creditors of corporations are already provided with adequate legal protections and safeguards under state law and federal bankruptcy law, and thus an additional level of protection via a claim for breach of fiduciary duty is unnecessary.

Second, that allowing a direct breach of fiduciary duty claim will create problems with corporate governance, causing uncertainty for directors who need to exercise their business judgment in the best interest of the insolvent corporation, and creating a potential conflict of interest between the directors' duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it and a newly recognized fiduciary duty to individual creditors.

The significance of the *Waugh* decision must be viewed in the context of the current healthcare environment. Bankruptcies of healthcare providers have been increasing over the last several years, a trend that many restructuring professionals expect to continue in 2011. In addition, the enactment of the Patient Protection and Affordable Care Act represents arguably the most significant change to the healthcare provider financing model since Medicare and Medicaid were passed into law in 1965. Significant uncertainty exists throughout the healthcare provider sector as identification of the financial "winners" and "losers" in a post healthcare reform economic environment remains highly fluid and uncertain. It is within such a void that aggressive creditors could flourish with novel assertions of individual fiduciary liability. Accordingly, the decision of a prominent supreme court of a state outside of Delaware serves to firmly establish the *bona fides* of the *Gheewalla* and *Trenwick* decisions and offer a powerful legal deterrent to the arguments of creditors seeking to assert direct breach of duty claims against the officers and directors of financially distressed healthcare companies.[3]

By consistently applying the business judgment rule across financial-distress scenarios and eliminating directors' fiduciary obligations to creditors, these decisions have loosened the perceived restraints upon the directors of distressed hospitals in an increasing number of jurisdictions. Counsel to such organizations thus will be better positioned to guide their clients' boards through otherwise difficult decision-making processes.

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However, hospital directors and their advisors must continue to recognize that reasonable diligence must be exercised by the board in order to gain the protections of the business judgment rule. The authors believe that *Gheewalla's* rationale and ruling ultimately will be adopted by courts throughout the country and applied to both for-profit and nonprofit directors, but until such time directors of distressed organizations will continue to be the target of fiduciary-liability claims.

Consequently, vigilance in the performance of board duties is crucial not only to the future of the hospital, but also to the director's defense against fiduciary-liability claims. *Waugh,* the Delaware cases and their progeny do not condone inattentiveness or a "business as usual" approach during times of financial distress, particularly when charitable assets may be at risk. These decisions are not a license for lax director oversight particularly under difficult organizational circumstances. The business judgment rule expects that prudent directors will respond as necessary to address the problems at hand. In this regard, evidence of a clear and deliberate process by which directors evaluate the corporation's financial distress in good faith and on an informed basis is crucial to achieving business judgment protections and deflecting public and regulatory criticism. Counsel should consult relevant state law to confirm the appropriate standard of conduct in financial distress circumstances – and to determine whether any case law exists suggestive of a direct cause of creditor action against officers and directors.

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[1] *Trenwick America Litigation Trust v. Ernst & Young, LLP*, 906 A.2d 168 (Del. Ch. 2006), *aff'd, Trenwick America Litigation Trust v. Billet et al.*, 2007 Del. LEXIS 357 (Del. Aug. 14, 2007).

[2] 906 A.2d at 205.

[3] Courts in several other jurisdictions presented with the same issue have similarly adopted the *Gheewalla* rationale and ruling. See *Master-Halco, Inc. v. Scillia, Dowling & Natarelli, LLC*, 2010 WL 1729172, at *2-3 (D. Conn. Apr. 5, 2010); *RSL Commc'ns PLC v. Bildirici*, 649 F. Supp. 2d 184, 206 (S.D.N.Y. 2009).

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