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Organizational Financial Distress: *Evolving Duties for Healthcare Directors*

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A series of recent creditors-rights decisions suggest that healthcare directors may have greater flexibility when responding to organizational financial distress.

For a number of years, risks associated with the harsh "zone of insolvency" and "deepening insolvency" theories of director liability have significantly constrained the manner in which governing boards address solvency concerns. Many courts have construed these theories to impose a higher standard of fiduciary conduct upon directors within proscribed periods of financial distress.[1] These interpretations have prompted the increasingly common practice by bankruptcy trustees and creditors' committees of complaining that board actions or omissions were responsible for the failure of the organization and the losses of its creditors.[2] This exposure to potentially enormous damages for breach of fiduciary duty has had a significant chilling effect on how directors choose to respond to solvency problems.

More recent decisions, however, could substantially reduce the fiduciary duty risks associated with these two theories. Courts in Delaware and elsewhere are increasingly reluctant to recognize deepening insolvency as an independent cause of action. Moreover, there is a growing movement among courts to evaluate director conduct under the deferential business judgment rule regardless of whether the organization was at the time solvent, insolvent, or in the zone of insolvency.

These are welcomed developments to healthcare directors, who are responsible for the strategic oversight of complex organizations that operate in a highly fluid industry, face enormous economic pressures, and must negotiate shifting regulatory challenges. While the favorable condition of the national economy in recent years generally has benefited healthcare providers on an industry-wide basis, it appears that the cycle is beginning to turn.[3] Indeed, there are increasing indications that standalone hospitals and smaller healthcare systems are encountering significant financial pressure that threatens their continued viability and reduces their attractiveness as candidates for merger or acquisition.

It is, thus, the combination of these new judicial decisions, the anticipation of a downward trend in the national economy, and the solvency pressures currently experienced by a growing number of providers, that warrants a review of the healthcare director's standard of conduct in periods of organizational financial distress.

Overview: Fiduciary Duties and the Zone of Insolvency

The basic fiduciary duties of care and loyalty are owed by directors and officers to the shareholders of a solvent business corporation or to the charitable mission of a solvent nonprofit corporation. The fundamental tenets of these fiduciary duties are generally the same for both business corporations and for nonprofit corporations.[4] The duty of care requires a director to discharge his or her duties as a director, including any duties as a member of a committee, (a) in good faith, (b) with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and (c) in a manner the director reasonably believes to be in the best interests of the corporation. Directors are thus obligated to acknowledge that their personal interests, and the interests of any constituency that they represent, must be subordinated to the best interests of

the corporation.[5] The duty of loyalty is generally considered to be subsumed within the mandate that directors act in good faith in a manner they reasonably believe to be in the best interests of the corporation.[6]

The fiduciary duties of care and loyalty are designed to protect the director who acts with common sense and informed judgment, and who innovates and takes informed risks consistent with corporate goals and objectives.[7] The duty of care in particular does not require a director to act with excessive caution or as the guarantor of success of a particular investment or activity. Rather, it allows the director leeway and discretion in the good faith exercise of his or her informed judgment.[8]

Directors of solvent corporations are generally entitled to the protections of the business judgment rule. The business judgment rule is a common law presumption (often incorporated into statute) that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action was taken in the best interests of the corporation, absent evidence of fraud, bad faith, or self-dealing.[9] The business judgment rule—a linchpin of Delaware corporate law, in particular—shields directors and officers from liability for losses attributable to an unwise business decision, so long as the decision was based on a rational business purpose and the directors and officers in fact complied with their fiduciary duties.

There is general agreement among the courts that directors and officers owe their fiduciary duties to creditors and other beneficiaries of the corporate enterprise when a corporation is insolvent, or enters the zone of insolvency (*i.e.,* a term describing a financially troubled corporation's descent into bankruptcy). This shift in duties constitutes an "insolvency exception" to the normal rule that fiduciary duties are owed solely to the corporation's shareholders or its charitable mission.[10] Courts disagree, however, about whether the business judgment rule is available when a corporation is insolvent or in the zone of insolvency.[11] Notably, courts applying Delaware law have held that a heightened level of scrutiny, rather than the deferential business judgment rule, should be used to evaluate the business decisions of directors and officers when the corporation is insolvent or approaching insolvency.[12]

Unfortunately, there is no-clear cut guidance on appropriate director conduct while the corporation is operating within the zone of insolvency. Rather, most of the insolvency-exception cases provide guidance on how directors should *not* act while operating within the zone, *e.g.:*

(a) Directors should not manipulate the assets, properties or liabilities of a subsidiary for the sole benefit of the parent corporation, such as by mortgaging a subsidiary's property to secure and pay loans of the parent;

(b) A director should not approve a major transaction that such director knows would benefit some or all of board members and harm the corporation;

(c) Directors should not forgive the debts of an insolvent corporation by improperly transferring corporate property or by making preferential payments; and

(d) Directors should not approve loans to insiders without consideration.

These and other vicissitudes of the insolvency exception have created confusion and uncertainty amongst many boards operating within the confines of the zone of insolvency. This confusion and uncertainty has in many cases constrained the board in terms of its pursuit of strategic initiatives that it may have otherwise thought prudent.

Overview: Deepening Insolvency

"Deepening insolvency" is an ill-defined legal theory that has been recognized as a cause of action in several jurisdictions and a theory of damages in others. Much like the heightened level of scrutiny applied by some courts to director conduct as the corporation approaches insolvency, deepening insolvency acts as a restraint on the strategic alternatives available to directors in times of financial crisis. Broadly stated, deepening insolvency exposes these directors to liability for an injury to corporate property caused by the expansion of debt and prolongation of corporate life. The basis for damages under this theory has evolved from a continuation of business purely for

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fraudulent or self-dealing reasons[13] to include actions for mere negligence (*e.g.*, actions taken by the board without sufficient attentiveness).[14]

Recent Judicial Decisions

Two recent decisions by the influential Court of Chancery in Delaware may provide directors with much-needed relief from the harsh applications of the insolvency exception and deepening insolvency. The Chancery Court held in these cases that the business judgment rule applies under Delaware law when directors make decisions in good faith and on an informed basis, regardless of whether the corporation is insolvent or in the zone of insolvency. The Chancery Court also joined an increasing number of courts in holding that a board is not required to wind down operations and liquidate assets when the corporation is insolvent, but may, in accordance with their fiduciary duties, decide to take on additional debt in an attempt to improve the corporation's financial performance.[15]

In *Production Resources Group, L.L.C. v. NCT Group, Inc.*, the Chancery Court emphasized that neither the nature of the fiduciary duties owed by directors and officers nor the standard of scrutiny applied to their decisions changes as the corporation approaches insolvency. Rather, the existence of financial distress simply causes the class of persons to whom fiduciary duties are owed to expand to the corporation's creditors.[16] The court also held that "the business judgment rule remains important and provides directors with the ability to make a range of good faith, prudent judgments about the risks they should undertake on behalf of troubled firms."[17] Central to the court's decision was the notion that the directors and officers of an insolvent or nearly-insolvent corporation should have the flexibility to pursue riskier turn-around strategies without being exposed to liability for breach of fiduciary duty if the chosen course of action fails.

In *Trenwick America Litigation Trust v. Ernst & Young LLP*, the Chancery Court reaffirmed its commitment to the business judgment rule by holding that Delaware law does not recognize an independent cause of action for deepening insolvency.[18] In doing so, the court stated that "[i]f the board of an insolvent corporation, acting with due diligence and good faith, pursues a business strategy that it believes will increase the corporation's value, but that also involves the incurrence of additional debt, it does not become the guarantor of that strategy's success."[19] Thus, "[e]ven when the company is insolvent, the board may pursue, in good faith, strategies to maximize the value of the firm."[20] An appeal of the decision is now pending before the Delaware Supreme Court, oral argument having been heard on March 14, 2007. Given the deference accorded by courts throughout the country to business law decisions by Delaware's highest court, the importance of the pending appeal of the Chancery Court's decision in *Trenwick* cannot be overstated.

Advising Boards Post-*Trenwick*

Consistent application of the business judgment rule to financial distress scenarios would be a favorable development for healthcare directors. By removing uncertainty as to the appropriate standard of director conduct, directors may feel much less constrained in financial distress situations to act in a manner they reasonably believe to be in the best interests of the corporate enterprise and its constituencies. Flexibility notwithstanding, it is important to recognize that the business judgment rule presupposes "that judgment—reasonable diligence—has in fact been exercised. A director cannot close his eyes to what is going on about him in the conduct of the business of the corporation and have it said that he is exercising business judgment."[21] Moreover, the existence of mounting debt will continue to be a material factor that board members must thoughtfully consider when addressing financial problems. As noted by the Chancery Court in *Trenwick*, "No doubt the fact of insolvency might weigh heavily in a court's analysis of . . . whether the board acted with fidelity and care" in making decisions of strategic importance.[22]

Evidence of a clear and deliberate process by which the members of the board evaluate the corporation's financial distress in good faith and on an informed basis is crucial to achieving the protections of the business judgment rule and deflecting public and regulatory criticism. Such a process should include the following actions:

1. A commitment to attending meetings, becoming educated about the issues and potential solutions, and voting when board action is required;
2. Identification and monitoring of key measures of financial health;
3. Appointment of a special committee of disinterested directors to study the issues and make strategic recommendations to the full board of directors;
4. Engagement of appropriate professional advisors and utilization of executive staff to guide the committee and the board in their consideration of strategic options;
5. Development of a specific timetable for resolution of the basic solvency issues facing the corporation, and application of conflicts of interest policies and

background fiduciary education to committee members;

6. Evaluation of:
   (a) The current financial condition of the facility;
   (b) Management's perspective of the causes of the distress;
   (c) Financial projections for the facility based on the status quo;
   (d) Availability of additional sources of financing/governmental assistance;
   (e) The strategic options to address the cause of the distress, *e.g.*, staffing reductions, realignment of certain services, reduction in bed size or service, change in status from acute care hospital to ambulatory or other alternate use, liquefaction of assets, change in control to other healthcare provider, closure, etc.
   (f) Consideration of the impact on the Community, and on access to care of the various strategic options;
   (g) Evaluation of the impact of the distress—and available options—on all other component parts of the healthcare system, differing strategic options (including the status quo); and
   (h) A review of the regulatory environment, applicable legal issues;
7. Consideration of advantages and disadvantages of the various available strategic options (*see* 6(e), above); and
8. Adoption of the selected strategic option, and implementation of related actions to

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achieve the option (including internal and external communications).

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END NOTES

1 Notably, there continues to be a paucity of decisions concluding that "zone of insolvency" principles actually apply to board members of nonprofit corporations.

2 *See, e.g., Gottlieb v. Hicks, et al.*, C.D. Cal., Case No. CV04-7318 (claims for breach of fiduciary duties asserted by Chapter 7 Trustee); *Official Comm. Of Unsecured Creditors v. Ricks et al. (In re Boston Regional Med. Ctr., Inc.)*, 328 F. Supp. 2d 130 (D. Mass. 2004) (claims for breach of fidudiciary duty asserted by creditors' committee). In *Gottlieb v. Hicks*, the Chapter 7 Trustee of Granada Hill Community Hospital filed a lawsuit against the hospital's board of directors and executive officers, as well as the officers' turnaround management company, alleging that breaches of fiduciary duties caused the hospital's failure and the creditors' losses. In January 2006, the district court dismissed the claims against the director-defendants, determining that they were entitled to protection by the business judgment rule. The Trustee has appealed the summary judgment to the Ninth Circuit Court of Appeals, while the case against the officers and their management company continues in the district court.

3 *See* Peter Edmonston, *After the Buyouts, Lawyers Prepare to Wrap Bandages*, N.Y. TIMES, Apr. 4, 2007. According to the Administrative Office of the U.S. Courts, business bankruptcy filings fell to a 10-year low in 2006. During the first quarter of 2007, however, business bankruptcy filings increased 70% over the first three months of 2006.

4 *See* Lizbeth A. Moody, "The Who, What, and How of the Revised Model Nonprofit Corporation," 16 N. KY. L. REV. 251, 256 (1989).

5 ABA, REVISED MODEL NONPROFIT CORP. ACT, § 8.30(a)(1987).

6 *Id.*, § 8.30, cont. 4.

7 GUIDEBOOK FOR DIRECTORS OF NONPROFIT CORPORATIONS, Second Edition, 29 (Overton and Frey, Editors).

8 *See supra,* note 5 at § 8.30, cont. 2.

9 *In re Walt Disney Derivative Litigation,* Case No. 411, 2005 (Del. June 8, 2006); *In re the Walt Disney Company Derivative Litigation,* Del. Ch., C.A. No. 15452; 2005 Del. Ch. LEXIS 113 (Aug. 9, 2005) (hereinafter, *Disney*).

10 The economic basis for the shift in duties, at least in the business corporation context, is relatively straightforward: before insolvency, the corporation was owned by the shareholders, but upon insolvency, the creditors assume equitable ownership because they are the only parties who maintain an interest in the assets of the corporation. *See Steinberg v. Kendig et al. (In re Ben Franklin Retail Stores, Inc.)*, 225 B.R. 646, 653 (Bankr. N.D. Ill. 1998) (" The economic rationale for the 'insolvency exception' is that the value of the creditors' contract claims against an insolvent corporation may be affected by the business decisions of managers. At the same time, the claims of the shareholders are (at least temporarily) worthless. As a result it is the creditors who 'now occupy the position of residual owners.'")

11 Peregrine, Schwartz, Burgdorfer and Gordon, "The Fiduciary Duties of Healthcare Directors in the 'Zone of Insolvency,'" 35 J. HEALTH L. No. 2 (Spring 2002).

12 *E.g., Jewel Recovery, LP v. Gordon*, 196 B.R. 348, 354 (N.D. Tex. 1996) ("Delaware law recognizes that when a corporation becomes insolvent, the assets of the corporation become a trust for the benefit of the corporation's creditors. The corporate directors then hold a fiduciary duty as trustees to protect the assets for the creditors."); *Miramar Res., Inc. v. Schultz (In re Schultz)*, 208 B.R. 723, 729 (Bankr. M.D. Fla. 1997) (holding that directors of an insolvent corporation owe duties as trustees under Delaware law).

13 *See Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 347 (3d Cir. 2001).

14 *See Smith v. Arthur Andersen LLP*, 421 F.3d 989, 995 (9th Cir. 2005).

15 *See, e.g., Trenwick America Litigation Trust v. Ernst & Young, LLP*, 906 A.2d 168, 204 (Del. Ch. 2006).

16 863 A.2d 772, 793 (Del. Ch. 2004).

17 *Id.* at 788 n.52.

18 906 A.2d at 205.

19 *Id.*

20 *Id.* at 204.

21 *Burt v. Irvine,* 47 Cal. Rptr. At 406-408 (Cal. Ct. App. 1965).

22 906 A.2d at 205.