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New Guidance for Directors of Financially Distressed Hospitals

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Hospital directors have a difficult and demanding job even in the best of times. They are responsible for the strategic oversight of complex organizations that operate in a highly fluid industry, face enormous economic pressures, and must negotiate shifting political and regulatory challenges. During periods of organizational financial distress, the normal challenges and pressures faced by hospital board members become more intense. A successful turnaround requires great effort, commitment, and leadership from the board. The directors must assess the potentially complex causes of distress and then oversee the development and implementation of a strategy designed to improve performance, increase cash flow, reduce debt, secure the delivery of high-quality services, and strengthen the hospital's relationships with medical staff, third-party payors, and trade creditors. These directors also must perform their responsibilities under a microscope of public scrutiny and the ever-present threat of litigation and personal liability.

Over the past fifteen years, bankruptcy trustees, creditors' committees, and individual creditors have become increasingly aggressive in pursuing claims against the boards of distressed hospitals. These plaintiffs often look beyond the traditional statutory and contractual theories of recovery. Today, hospital bankruptcies regularly culminate in highly publicized lawsuits against the directors for breach of fiduciary duty and deepening insolvency. These lawsuits have a rippling effect that undoubtedly causes some directors to eschew risk in favor of self-preservation at precisely the time when the hospital needs strong leaders and innovative strategies.

Fortunately for the directors of hospitals and other corporations organized in Delaware, two recent court decisions by the Delaware Supreme Court have firmly rejected the theory of deepening insolvency and the ability of creditors to assert direct fiduciary claims under Delaware law.¹ First, in May 2007, the Delaware Supreme Court held in *North American Catholic Programming Foundation v. Gheewalla, et al.*,² that creditors do not have standing to assert direct claims for breach of fiduciary duty against direc-

tors, regardless of whether the corporation was during the relevant period of time insolvent or in the so-called "zone of insolvency." Three months later, in *Trenwick America Litigation Trust v. Billett, et al.*,³ the Delaware Supreme Court refused to recognize a cause of action for deepening insolvency under state law.

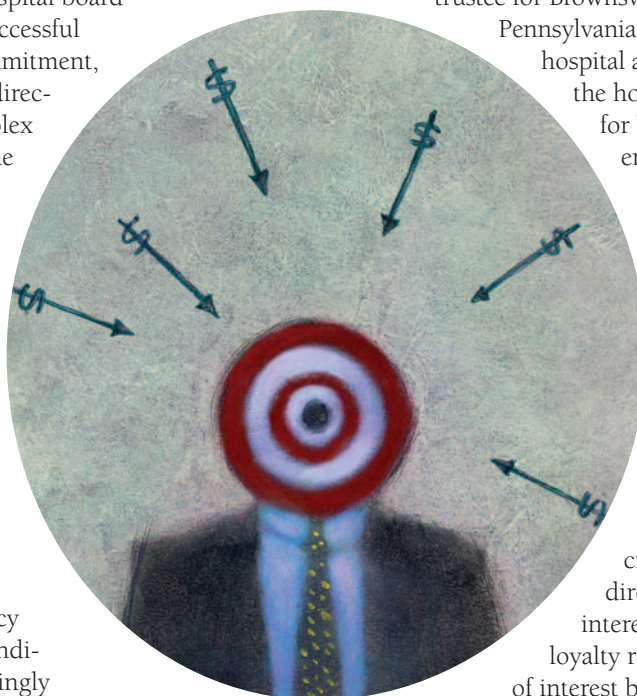
In light of the great deference accorded throughout the U.S. to decisions by the Delaware Supreme Court on matters of corporate law and governance,⁴ the decisions in *Gheewalla* and *Trenwick* may influence courts outside of Delaware to provide directors with greater protections and flexibility to deal with organizational distress.⁵ We must emphasize, however, that directors of financially distressed hospitals will continue to be the target of fiduciary-liability claims until decisions such as *Gheewalla* and *Trenwick* become widely accepted and respected principals of corporate law and governance in the U.S. For example, shortly before the publication date of this article, and several months after the *Gheewalla* and *Trenwick* opinions were issued, the liquidation trustee for Brownsville General Hospital in Brownsville, Pennsylvania, filed a complaint on behalf of the hospital and creditors seeking damages against the hospital's former directors and officers for breach of fiduciary duty and deepening insolvency.⁶

I. Fiduciary Duties and the Business Judgment Rule

Directors owe fiduciary duties to the corporation and its shareholders. The fiduciary duty of care requires a director to discharge his or her board responsibilities in good faith; with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and in a manner the director reasonably believes is in the best interests of the corporation.⁷ The duty of loyalty requires a director to avoid conflicts of interest by setting aside his or her personal interests in a given matter involving the corporation.⁸

The duties of care and loyalty protect the director who acts with common sense and informed judgment, and who innovates and takes informed risks consistent with corporate goals and objectives.⁹ These fiduciary duties do not require the director to act with excessive caution or to guarantee the success of a particular strategy or activity.¹⁰ Rather, they provide the director with discretion in the good faith exercise of his or her informed judgment.¹¹

Courts typically review fiduciary claims against directors under the deferential business judgment rule. The business judgment rule is a presumption that in making a decision the directors acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.¹² The rule has long stood for the proposition that courts should refrain from second-guessing the business decisions of directors, who are presumed to be in a better position than courts in



guiding the corporation's affairs.¹³ The shield provided by the rule enables well-meaning and informed directors to perform their official duties without excessive concern that their decisions will be subject to litigation.¹⁴

II. Claims for Breach of Fiduciary Duty and Deepening Insolvency

In general, directors do not owe duties to creditors beyond their respective contractual terms.¹⁵ Over fifteen years ago, however, a decision by the Delaware Chancery Court in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.* suggested that directors may owe fiduciary duties to creditors when a corporation enters the “zone of insolvency.”¹⁶ *Pathe* was a monumental decision. The duty-shifting principles announced therein have been discussed and argued at great length by courts, litigants, and scholars throughout the country. Until recently, however, the Delaware Supreme Court had never discussed or even cited to *Pathe*. Without legal guidance from the Delaware's highest court, arguments have raged for many years over the meaning of “zone of insolvency” and whether directors of corporations in the zone may be liable directly to creditors for poor business decisions notwithstanding the business judgment rule.¹⁷ In *Gheewalla*, the Delaware Supreme Court finally resolved many of these open issues.

The plaintiff in *Gheewalla* was a member of an alliance that owned wireless spectrum licenses. The plaintiff and other alliance members signed an agreement to sell their licenses to a Delaware corporation named Clearwire Holdings, Inc. Before the sale was consummated, however, the market for wireless spectrum licenses collapsed. Clearwire sought to be released from its purchase obligations, but the negotiations with the plaintiff failed and Clearwire went out of business. The plaintiff filed suit against several of Clearwire's directors. The complaint alleged that Clearwire was insolvent or in the zone of insolvency at all relevant times, the defendant-directors owed fiduciary duties to plaintiff as a creditor of Clearwire, and the defendant-directors breached their fiduciary duties. Upon motion by the defendant-directors, the chancery court dismissed the complaint for failure to state a claim.¹⁸

The chancery court's dismissal was affirmed by the Delaware Supreme Court.¹⁹ In reaching its decision, the high court separately analyzed the fiduciary duties of directors of an insolvent corporation and the fiduciary duties of directors of a corporation in the zone of insolvency. The court explained that the creditors of an *insolvent* corporation may assert *derivative* claims for breach of fiduciary duty on behalf of the corporation, but they lack standing to assert *direct* fiduciary claims for their own losses.²⁰ The court further explained that the creditors of a *nearly insolvent* corporation do not have standing to assert *derivative* or *direct* claims for breach of fiduciary duty against the corporation's directors.

The *Gheewalla* court emphasized that burdening directors with fiduciary duties to creditors when a corporation is in the zone of insolvency would create a conflict with the duties owed by the directors to the corporation. The court explained that “an otherwise solvent corporation operating in the zone of insolvency is one in most need of effective and proactive leadership—goals



which would likely be significantly undermined by the prospect of individual liability arising from the pursuit of direct claims by creditors.”²² The court also provided much-needed clarity by eliminating the nebulous concept of a zone of insolvency, as follows:

In this case, the need for providing directors with definitive guidance compels us to hold that ***no direct claim for breach of fiduciary duties may be asserted by the creditors of a solvent corporation that is operating in the zone of insolvency.*** When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners. Therefore, we hold . . . [that the plaintiff creditor] fails to state a claim, as a matter of Delaware law, to the extent that it attempts to assert a direct claim for breach of fiduciary duty to a creditor while [the distressed company] was operating in the zone of insolvency.²³

In *Trenwick*, the Delaware Supreme Court further restrained the ability of creditors to sue directors by summarily affirming the chancery court's refusal to recognize deepening insolvency as an independent cause of action under Delaware law.²⁴ The plaintiff in *Trenwick* was a bankruptcy trustee and the defendants were the former directors of an insurance holding company subsidiary. The plaintiff charged that the defendant-directors had tortiously deepened the insolvency of the subsidiary corporation by acquiescing to the parent corporation's imprudent growth strategy and undertaking greater debt. In rejecting the plaintiff's deepening insolvency claims, the chancery court made clear that the “appropriate tool to examine the conduct of the directors is the traditional fiduciary duty ruler.”²⁵ The opinion also emphasized

that the business judgment rule applies to directors of “solvent, barely solvent, and insolvent corporations.”²⁶ In confirming the strength of the business judgment rule, the opinion adopted by the Delaware Supreme Court explained as follows:

[B]usiness failure is an ever-present risk. The business judgment rule exists precisely to ensure that directors and managers acting in good faith may pursue risky strategies that seem to promise great profit. If the mere fact that a strategy turned out poorly is in itself sufficient to create an inference that the directors who approved it breached their fiduciary duties, the business judgment rule will have been denuded of much of its utility.²⁷

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If 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 a guarantor of that strategy’s success. . . . Rather, in such a scenario the directors are protected by the business judgment rule. To conclude otherwise would fundamentally transform Delaware law.²⁸

III. Conclusion

Hospital directors have a vitally important but demanding job. The pressure upon many such directors will intensify as a growing number of hospitals, particularly small community hospitals, sink into financial distress.²⁹ Fortunately, the Delaware Supreme Court’s decisions in *Gheewalla* and *Trenwick* provide meaningful guidance on how directors of financially troubled hospitals should discharge their fiduciary duties. By consistently applying the business judgment rule across financial-distress scenarios and eliminating directors’ fiduciary obligations to creditors, the court has loosened the perceived restraints upon the directors of distressed hospitals in Delaware. Counsel to such organizations thus will be better positioned to guide their clients’ boards through otherwise difficult decision-making processes.

While *Gheewalla* and *Trenwick* are confined to Delaware law, the prominence of the Delaware Supreme Court in matters of corporate law and governance suggests that the effects of these decisions may expand to other states. 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. *Gheewalla* and *Trenwick* do not condone inattentiveness or a “business as usual” approach during times of financial distress, particularly when charitable assets may be at risk. 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.

- 1 Positive developments have occurred in other states, as well. For example, a U.S. Bankruptcy Court in Los Angeles recently approved a settlement agreement under which the bankruptcy trustee for Granada Hills Community Hospital voluntarily dismissed his claims for breach of fiduciary duty and negligence against the hospital’s former directors in return for a relatively small recovery. See *In re International Philanthropic Hosp. Found.*, Case No. 02-20579 (Bankr. C.D. Cal.). The settlement followed an earlier district court ruling that the directors were protected from the trustee’s claims under the “business judgment rule” contained in California’s Corporations Code. See *Gottlieb v. Hicks et al.*, Case No. 04-7318 (C.D. Cal. Jan. 13, 2006).
- 2 930 A.2d 92 (Del. May 18, 2007).
- 3 2007 Del. LEXIS 357 (Del. Aug. 14, 2007).
- 4 Delaware cases are worthy of note by nonprofit corporations because of the number of businesses incorporated in Delaware, the volume of business controversies litigated in Delaware courts, the strength of its judiciary (including the specialized chancery court, that has jurisdiction over cases arising under its corporate laws), and the fact that it has a unified corporation code for both for-profit and nonprofit corporations. Furthermore, Delaware decisions often address alleged violations of fiduciary duty that closely resemble those duties owed by directors of nonprofit corporations. Accordingly, rulings of Delaware courts on issues of director conduct can be particularly informative to nonprofit organizations and those who regulate them.
- 5 Indeed, the *Gheewalla* decision has been applied to cases arising under Texas law and Minnesota law. See *Mims et al. v. Fail et al. (In re Vartec Telecom, Inc.)*, 2007 Bankr. LEXIS 3240 (Bankr. N.D. Tex. Sept. 18, 2007); *Christians v. Grant Thornton, LLP*, 733 N.W.2d 803 (Minn. App. Ct. 2007).
- 6 *Bernstein v. Cancelmi et al. (In re Brownsville Gen. Hosp., Inc.)*, Adv. Proc. No. 07-02593 (Bankr. W.D. Pa. Nov. 30, 2007).
- 7 ABA, REVISED MODEL NONPROFIT CORP. ACT, § 8.30(a) (1987).
- 8 *Id.*, § 8.30, cont. 4.
- 9 GUIDEBOOK FOR DIRECTORS OF NONPROFIT CORPORATIONS, Second Ed., 29 (Overton and Frey, Editors).
- 10 ABA, REVISED MODEL NONPROFIT CORP. ACT, § 8.30, cmt. 2.
- 11 *Id.*
- 12 *In re Walt Disney Derivative Litig.*, 906 A.2d 27, 52 (Del. 2006); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).
- 13 See Michael W. Peregrine and James R. Schwartz, *Revisiting the Duty of Care of the Nonprofit Director*, 36 J. OF HEALTH L. 183 (Spring 2003).
- 14 See, e.g., *Burt v. Irvine Co.*, 47 Cal. Rptr. 392, 406-408 (Cal. Ct. App. 1965).
- 15 *Simons v. Cogan*, 549 A.2d 300, 304 (Del. 1988); *Production Res. Group v. NCT Group, Inc.*, 863 A.2d 772, 787 (Del. Ch. 2004).
- 16 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991).
- 17 See, e.g., *Jewel Recovery, LP v. Gordon*, 196 B.R. 348, 354 (N.D. Tex. 1996); *Miramar Res., Inc. v. Schultz (In re Schultz)*, 208 B.R. 723, 729 (Bankr. M.D. Fla. 1997). See also Michael W. Peregrine, James R. Schwartz, James E. Burgdorfer, and David C. Gordon, *The Fiduciary Duties of Healthcare Directors in the “Zone of Insolvency”*, 35 J. OF HEALTH L. 227 (Spring 2002).
- 18 *North American Catholic Programming Foundation v. Gheewalla*, 2006 WL 2588971 (Del. Ch. Sept. 1, 2006).
- 19 *Gheewalla*, 930 A.2d 92.
- 20 *Id.* at 102.
- 21 *Id.* at 100.
- 22 *Id.* at 100.
- 23 *Id.* at 101 (emphasis added).
- 24 *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).
- 25 906 A.2d at 205.
- 26 *Id.* at 195.
- 27 *Id.* at 193.
- 28 *Id.* at 205.
- 29 See *A Grim Prognosis*, THE AMERICAN LAWYER, Dec. 2007, p. 22.