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ABSTRACT: Directors of healthcare organizations normally owe fiduciary duties to their shareholders or, in the case of nonprofits, to the charitable mission of the organization. As an organization descends to bankruptcy, however, the board's duties may shift. At some point, the board may be imposed with different and often conflicting obligations to the corporate enterprise as a whole, with a primary criterion being the interests of creditors. In this article, the authors analyze the murky areas of the Zone and give guidance as to when the board's duty may shift—and as to how directors should proceed both in determining their duties and in working to fulfill them.

Conflicting Directive Obligations

The "Zone of Insolvency" (the Zone) is not the title of a B-grade science-fiction film; rather, it refers to an important but little-known concept of corporate law that may have a dramatic impact upon the manner in which healthcare corporate directors exercise their fiduciary obligations in situations of corporate financial distress. During the time period a corporation is in the Zone, the duties and obligations of the

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corporation's directors undergo a fundamental shift designed to benefit the corporate enterprise as a whole, and particularly to benefit the creditors. This generally is referred to as the "Insolvency Exception" to the general duty-of-care standards applicable to individual board member conduct.

Zone of Insolvency issues are of paramount concern in the healthcare industry not only because of the uncertain, and to some extent unfavorable, status of the healthcare economy, but also because of the myriad types of financing relationships existing between healthcare corporations that can create debtor/creditor relationships.[1] The failure of a board of directors to be responsive to creditor interests while the corporation is within the Zone can expose board members to a significant risk of liability.

It is also important to note that Zone of Insolvency issues arise for boards of directors of for-profit and nonprofit corporations alike—it is not a legal concept that has particular application to one form of legal entity and not to the other. Rather, it applies to corporate directors regardless of whether their basic duties are owed to shareholders (as in the case of a business corporation) or to a charitable mission (as in the case of a nonprofit corporation). Failure to acknowledge Zone issues could create significant liability exposure to the members of the board of directors of *any* type of healthcare corporate enterprise.[2]

The political implications of Zone issues underscore its unique and potentially volatile legal status. While the individual parties most directly impacted by the application of the Zone are the directors of the financially-distressed corporation (and the corporation's creditors), those directors normally are dependent upon the advice of senior management for a determination that the corporation may be insolvent or approaching insolvency. Indeed, it is reasonable to assume that senior executives are obligated to advise the board on financial conditions, including the potential for insolvency. Nevertheless, it is basic human nature to assume that most senior executives would be reticent to alert the board to the corporation's financial distress. Thus, the conflict among a board's need to be informed, management's duty to inform its board, and basic human nature creates a peculiar and imperfect tension that must be considered when advising clients concerning these issues.

Accordingly, this article will address application of Zone issues to healthcare corporations, with a particular focus on the obligatory shift in directors' duties in the Zone. Next, the authors will

examine the determination of insolvency, and how directors may be obligated to act during the period of insolvency. Finally, the article will offer practical observations on the impact of insolvency issues on traditional financial relationships in the healthcare industry.

I. Why is the Issue Relevant?

The vicissitudes of the healthcare financing system, competitive and economic pressures, rising costs, and the impact of a depressed securities market have combined to create further instability for an already-fragile healthcare financing model. In such an environment, the potential that any type of healthcare business corporation may be flirting with insolvency is no longer as unlikely as it may once have been. Nevertheless, the potential for insolvency, and the impact on directors' duties when the corporation is in the Zone, may be foreign issues for the corporate board. The related potential liability exposure to creditors for breach of fiduciary duty would thus become a lurking landmine for the unsuspecting board. In such a situation, legal counsel (both in-house and outside) may be of substantial assistance in making clients generally aware of this legal concept and of related duties and obligations of management and the board.

II. What is the "Insolvency Exception?"

The Insolvency Exception refers to the deviation from the accepted standards of director conduct that applies when a corporation is in the Zone, a term that describes a financially troubled corporation's descent into bankruptcy.

Corporate directors generally owe fiduciary duties to the corporation they serve—to its shareholders in the context of the business corporation, or to the corporation's charitable mission and the constituents thereof in the context of a nonprofit corporation. The duties of care and loyalty describe the manner in which directors are required to exercise their basic fiduciary obligations.[3] Of these duties, it is the duty of care that relates most directly to daily corporate operations and thus which is principally implicated by the potential of corporate insolvency.

The fundamental tenets of the duty of care are generally the same for both business corporations and for nonprofit corporations.[4] The duty of care requires a director to discharge his duties as a director, including his 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.[5]

Recent amendments to the American Bar Association's (ABA's) Model Business Corporation Act slightly amend the second criterion, for business corporations, to instead read as follows:

> (b) The members of the board of directors or a committee of the board, when becoming informed in connection with their decision-making function or devoting attention to their oversight functions, shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.[6]

Conflicting Directive Obligations

The corporate duty of care permits a director, in discharging his duties, to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

> (1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;
>
> (2) legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the person's professional or expert competence; and
>
> (3) a committee of the board of which the director is not a member, as to matters within its jurisdiction, if the director reasonably believes the committee merits confidence.[7]

However, a director will not be considered to be acting in good faith, and thereby justifiably relying on this information, if he has contrary knowledge concerning the matter in question.[8]

The duty of care is 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.[9] *The duty of care does not require that a director act with excessive caution or be a guarantor of success of a particular investment or activity; it allows leeway and discretion in the exercise of judgment.*[10]

The duty of loyalty generally is 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."[11] This mandate reflects the fundamental premise that corporate directors and officers occupy positions of trust and confidence, upon which their colleagues may rely. By accepting this position, the director acknowledges that his personal interests, and the interests of any constituency which he may represent, must be subordinated to the best interests of the corporation.[12] As noted, in the nonprofit context, "loyalty" connotes an absolute allegiance to the corporation's charitable purposes; the director is prohibited from using his position or confidential corporate information in order to achieve financial benefit for himself or for a third person, including another charitable corporation.[13]

Conflicting Directive Obligations

The Business Judgment Rule (the Rule) is the traditional rule under which courts have evaluated duty of care-related decisions by boards of directors, particularly of business corporations. While few cases to date have directly applied the Rule to nonprofit corporations,[14] progressive public policy, as well as the ABA's Revised Model Nonprofit Corporation Act, support application of the Rule to nonprofit corporations.[15]

The Business Judgment Rule provides protection for prudently—acting directors and their decisions. It reflects a fundamental presumption "that business decisions are made by disinterested and independent directors on an informed basis and with a good faith belief that the decision will serve the best interests of the corporation."[16] Courts will apply the Business Judgment Rule as a form of judicial gloss on the basic duty-of-care standards applicable to a director's exercise of business judgment.[17] As applied by the Model Act, the Business Judgment Rule and the duty of care are complementary. In other words, the Business Judgment Rule need not to be applied if a director has satisfied the standards of a statutory duty of care; it would only be applied if compliance with the statutory standard were not established.[18] Where the "due care" standard includes within its scope an "ordinarily prudent person" and a "reasonable inquiry" provision—and where the state's courts interpret the language literally—a two-part test is created. Under the first part of the test, the

board's decisionmaking process is evaluated to determine if the board conducted a level of inquiry that an ordinarily-prudent person would have used under similar circumstances.[19] This is, essentially, a "simple negligence" test. Under the second part of the test, the board's actual decision is exempt from challenge, provided that certain criteria are satisfied and that the decision is not irrational.[20] As noted by a California appellate court:

> The question is frequently asked, how does the operation of the so-called "business judgment rule" tie in with the concept of negligence? There is no conflict between the two. When courts say they will not interfere in matters of business judgment, it is presupposed 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]

Thus, in litigation focused upon the appropriateness of a board decision, the Business Judgment Rule limits the judicial inquiry to the determination of whether the plaintiff has overcome the basic presumption that business decisions are made by disinterested and independent directors on an informed basis and with a good-faith belief that decisions will be in the best interests of the corporation.[22] If the plaintiff is unable to overcome this presumption, the court will not proceed further to examine the merits of the specific business decision.[23] The Rule reflects a core concept that courts are reluctant to second-guess decisions by directors regarding the conduct of business.

When applied by courts, the Business Judgment Rule typically protects the board from liability for decisions that ultimately yield unfavorable results, yet were arrived at reasonably. Meritorious as the rule may be, however, state attorneys general often are reluctant to support application of the Business Judgment Rule to nonprofits.

As noted above, these basic fiduciary duties are owed to the shareholders of the business corporation, and to the corporation, its charitable mission and the beneficiaries thereof, with respect to a nonprofit corporation. Directors of *solvent* corporations—be they business or nonprofit—do *not* owe these or other fiduciary duties to creditors, or to any other constituency of the corpora-

tion enterprise. That concept is subject to challenge, however, with respect to business or nonprofit corporations operating in the Zone.

The Insolvency Exception represents a substantial variation from the traditional duty of care, and applies when the corporation enters the Zone, as will be described more fully. During this period, the directors are obligated to exercise their fiduciary duties in the best interests of the corporate enterprise, including the creditors of the corporation, the employees, or other constituent groups, rather than exclusively to the shareholders or to the charitable mission and the beneficiaries thereof. It is when the corporation enters the Zone that fiduciary duties for the benefit of creditors are created; these duties arise as a result of insolvency itself and not the instigation of statutory bankruptcy or insolvency proceedings.[24]

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.[25] Accordingly:

> 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."[26]

For example, if the assets of an acute care hospital were valued at $50 million, but its liabilities were in excess of $50 million, the Insolvency Exception dictates that the creditors bear the primary "downside" risk of hospital management decisionmaking, while the shareholders or the charitable mission would benefit from the "upside." Accordingly, under the doctrine, directors should shift their fiduciary attention to preserving the value of the creditors' claims.[27]

The corporate enterprise approach to this shift in fiduciary duty was explained in the recent District Court decision of *Steinberg v. Kendig*.[28] "[W]here a corporation is operating in the vicinity of

insolvency, a board of directors is not merely the agent of residue risk bearers, but owes its duty to the corporate enterprise."[29] In managing the business affairs of the corporation, the directors' supervening loyalty is to the corporation, and the board has "an obligation to the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity."[30] This is especially true when a corporation is in the vicinity of insolvency, because the "possibility of insolvency can do curious things to incentives, *exposing creditors to risks of opportunistic behavior*, and creating complexities for directors."[31] In its seminal *Credit Lyonnais*[32] decision, the Delaware Chancery Court provided a useful example of the risks posed to creditors within the Zone:

> Consider, for example, a solvent corporation having a single asset, a judgment for $51 million against a solvent debtor. The judgment is on appeal and thus subject to modification or reversal. Assume that the only liabilities of the company are to bondholders in the amount of $12 million. Assume that the array of probable outcomes of the appeal is as follows:

Conflicting Directive Obligations

	Expected Value
25% chance of affirmance ($ 51 mm)	$12.75
70% chance of modification ($ 4 mm)	2.8
5% chance of reversal ($ 0)	0.0
Expected Value of Judgment on Appeal	$15.55

> Thus, the best evaluation is that the current value of the equity is $3.55 million. ($15.55 million expected value of judgment on appeal [minus] $12 million liability to bondholders). Now assume an offer to settle at $12.5 million (also consider one at $17.5 million). By what standard do the directors of the company evaluate the fairness of these offers? The creditors of this solvent company would be in favor of accepting either a $12.5 million offer or a $17.5 million offer. In either event they will avoid the 75% risk of insolvency and default. The stockholders, however, will plainly be opposed to acceptance of a $12.5 million settlement (under which they get practically nothing). More impor-

tantly, they very well may be opposed to acceptance of the $17.5 million offer under which the residual value of the corporation would increase from $3.5 to $5.5 million. This is so because the litigation alternative, with its 25% probability of a $39 million outcome to them ($51 million–$12 million–$39 million) has an expected value to the residual risk bearer of $9.75 million ($39 million x 25% chance of affirmance), substantially greater than the $5.5 million available to them in the settlement. While in fact the stockholders' preference would reflect their appetite for risk, it is possible (and with diversified shareholders likely) that shareholders would prefer rejection of both settlement offers.

But if we consider the community of interests that the corporation represents it seems apparent that one should in this hypothetical accept the best settlement offer available providing it is greater than $15.55 million, and one below that amount should be rejected. But that result will not be reached by a director who thinks he owes duties directly to shareholders only. It will be reached by directors who are capable of conceiving of the corporation as a legal and economic entity. Such directors will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.[33]

Conflicting Directive Obligations

It should be noted that some courts apply a more restrictive view of the "community of interest" to which directors owe fiduciary duties upon the corporation's insolvency. Rather than referring to the corporate enterprise as a whole, they provide that the shift in duties causes the directors to become "trustees for the creditors," which means that the corporate assets are to be used as a trust fund solely for the benefit of creditors.[34] Care should be taken, therefore, to consider whether the law in the relevant jurisdiction applies a "creditors-only" or a "corporate-enterprise"

approach. Directors of healthcare corporations in the Zone located in corporate-enterprise jurisdictions may conceivably be called upon to balance the interests of constituent groups other than the corporate creditors; these groups could include employees, the medical staff, and healthcare consumers—as well as (potentially) the shareholders/charitable mission.

The board of directors may also be called upon to evaluate its obligations according to the different types of claims asserted by both secured and unsecured creditors. A related complicating factor would be judicial recharacterization of creditor claims in accordance with a debtor/creditor doctrine, such as equitable subordination or fraudulent transfer, to place a lower priority upon, or completely eliminate, a creditor's claim.[35]

In terms of assessing liability exposure for board actions in the Zone, directors should keep in mind the profile of parties that experience suggests will be raising breach of fiduciary duty allegations. The most litigious group is likely to include: (1) creditors holding large claims; (2) formal and informal creditor committees that are well-represented by counsel; (3) the United States Trustee's Office, a division of the Department of Justice; (4) plaintiffs' attorneys; and (5) Chapter 7 or 11 bankruptcy trustees who upon appointment replace management and are responsible for liquidation of the assets (a "Chapter 7 Liquidation") or reorganization of the corporation's assets (a "Chapter 11 Reorganization"). Furthermore, it is likely in bankruptcy cases that Zone litigation will be instituted in a federal bankruptcy court, which may offer a less predictable forum in terms of procedure, and potentially in terms of outcome.

III. Are There Any Residual Duties Owed?

The relevant cases lack consistency in addressing the important question of whether directors of corporations operating in the Zone owe duties to shareholders or to the charitable mission as well as to the creditors and, depending upon the jurisdiction, the remainder of the corporate enterprise.[36] In other words, there appears to be no uniform approach to the issue of whether directors of the insolvent corporation owe the entirety of their fiduciary duty to creditors, or whether there simultaneously are residual duties owed to the shareholders or to the charitable mission. This issue is, of course, of foremost interest to the board.

One approach is represented by the 1982 decision of the Fourth Circuit in *Federal Deposit Insurance Corp.* (FDIC) *v. Sea Pines Company,*[37] which reflects a creditors-only perspective:

> The law by the great weight of authority seems to be settled that when a corporation becomes insolvent, or in a failing condition, the officers and directors no longer represent the stockholders, but by the fact of insolvency, become trustees for the creditors, and that they cannot by transfer of its property or payment of cash, prefer themselves or other creditors.[38]

Sea Pines involved an action brought by the FDIC to enforce a guarantee of a construction loan made by a parent corporation for the benefit of its subsidiary. The subsidiary later sold the property that was the subject of the loan and leased it back. When the subsidiary subsequently became insolvent, it cancelled the sale and leaseback, thereby canceling the parent guarantee, and mortgaged the property to pay the debts of the parent. The Court of Appeals "pierced the veil" of the parent/subsidiary relationship, highlighting the role of the common directors of the parent and the subsidiary. It ruled that, through the two transactions, the common directors violated their fiduciary duty to creditors of the insolvent subsidiary by using the assets of the subsidiary to benefit the parent.[39]

This creditors-only perspective also is reflected in a 1990 District Court decision, *First Options of Chicago Inc. v. Polonitza,*[40] involving an alleged breach of duty by the president-director of an insolvent corporation in approving a setoff transaction forgiving a corporate loan made to the president's son. The District Court approved the following jury instruction:

> An officer and director of an insolvent corporation has a duty to the corporation's creditors to be loyal, *to act solely for the financial benefit of the creditors in all matters,* and to enhance the financial interest of the insolvent corporation.[41]

The corporate enterprise approach is represented by the decision of the Bankruptcy Court in *In re Xonics, Inc.,*[42] which reflects the perspective that, where a corporation is insolvent, its officers and directors stand in a position of trust not only to the corporation and its shareholders, but also to its creditors:

> [C]reditors have no standing to sue an officer or director under Delaware Law unless it has been established that the corporation was insolvent. When a corporation is insolvent its officers and directors stand in a position of trust *not only to the corporation and its shareholders, but also to its creditors.*[43]

A similar view was adopted by the Delaware Court of Chancery in a fiduciary duty action brought against corporate officers by former employees for failing to provide for retirement benefits following the dissolution of the corporation.[44] One of the defenses asserted by the plaintiffs was that the defendants lacked standing to pursue a breach of fiduciary duty claim because they were neither creditors nor shareholders of the corporation. The court acknowledged the general rule that a plaintiff must be a shareholder of a corporation to pursue a breach of fiduciary claim against corporate directors, but the court noted that, "[o]nce a corporation dissolves, however, its assets are held in trust for the benefit of both its creditors and its stockholders."[45] Accordingly, once the corporation was dissolved, the director defendants owed fiduciary duties not only to the former stockholders of the corporation, but to its creditors as well.[46]

In jurisdictions that recognize the existence of residual duties to the shareholders, however, the question remains as to the allocation of those duties—whether they are primarily to be exercised in favor of one group of interested persons over the other, or equally. As the issue applies to nonprofit corporations, the question becomes even more acute as to whether and to what extent there are residual duties owed to the nonprofit mission. The authors believe that some courts may feel compelled to acknowledge some residual duty to the charitable mission, or at least the attorney general will assert a residual duty, but, as the following discussion indicates, there is almost no relevant law on point.

IV. By What Standard Will Director Conduct be Evaluated?

Once the *scope* of the director's duty is established, either 100% to creditors or with some residual duty to the shareholders or mission, the other critical issue to be resolved is by what *legal standard* will the director's conduct in conformance with those duties be evaluated. Again, the relevant case law reflects an inconsistency in addressing this issue. One line of cases follows the "trust fund" approach described previously, and defines

directors' standards of conduct in the Zone according to trust law principles. The other line of cases would apply the screen of the Business Judgment Rule to evaluate director conduct. From the perspective of potential director liability, there is a substantial gap in these differing judicial approaches.

A. *Trust Law Standard*

Generally speaking, trust law principles would hold corporate directors to a much higher standard of care than the recognized standards adopted under the Revised Model Act's definition of the duty of care. There are several important differences between the trust law standard and that applicable to corporate directors. First, trustees typically are held liable for acts of simple negligence in the performance of their duties, in contrast to the protection afforded by the Business Judgment Rule for directors.[47] Second, there is a complete ban on self-dealing actions by trustees; whereas directors may, with certain specific safeguards in place, participate in transactions that involve conflicts of interest.[48] Finally, trustees typically are prohibited from delegating their duties, while directors have more latitude in that respect.[49]

This trust fund approach is best demonstrated by the 1953 decision of the New York Court of Appeals in *New York Credit Men's Adjustment Bureau, Inc. v. Weiss*,[50] in which the court was called upon to evaluate the conduct of directors of a corporation who elected to wind up the corporation's affairs because of its financial condition. The directors had determined that a public auction sale was the most appropriate course of "wind-up" action, but the sale failed to generate sufficient assets to prevent a subsequent involuntary bankruptcy petition.[51] The bankruptcy trustee alleged that the directors breached their fiduciary duty by failing to obtain fair value for the corporation's assets. The *Credit Men's* court concluded that the corporate directors were in the position of trustees of corporate assets for the benefit of corporate creditors, and thus had an obligation to demonstrate that this authorization of the auction sale "did not occasion an improper or improvident depletion of the trust *res*."[52] The directors were thus liable for damages to the extent the auction sale realized less than the full value of the assets, and a trial was ordered to assess the amount of damages.[53]

B. *Business Judgment Rule Standard*

A second line of cases applies the Business Judgment Rule to evaluate director conduct in the Zone. In jurisdictions that apply

the Business Judgment Rule to such situations, directors are less likely to be found to have violated the standard of conduct applicable in the Zone, as long as the preconditions for application of the Rule's protection have been established.

The Business Judgment Rule was explicitly applied to evaluate director conduct in the Zone in the recent Delaware decision, *Angelo, Gordon & Co., L.P., v. Allied Riser Communications Corp.*[54] Here, the court was called upon to assess plaintiff claims that, given Allied Riser's insolvent status, the board's decision to pursue a specific merger opportunity constituted a breach of the duty owed to creditors. Applying the Rule, the court concluded that the plaintiffs failed to satisfy their burden of proving that the corporate directors failed to act prudently and in good faith in connection with the merger proposal.[55]

The Business Judgment Rule approach is also demonstrated in a 1993 decision of the Supreme Court of New York, Judge Shainswit, in *Curiale v. Reissman,* which was subsequently affirmed in an unpublished decision of the Appellate Division.[56] In *Curiale,* Judge Shainswit applied the logic of the dissent in *Credit Men's* to uphold the conduct of directors of a failing savings and loan association.[57] One of the allegations in *Curiale* was that the directors had breached their fiduciary duty to one group of creditors by favoring claims of other creditors; thereby reducing the pool of assets available to address the claims of all creditors.[58] The court determined that the directors had taken their action on the mistaken belief that the decision to favor one group of creditors was required by governmental regulations, and, accordingly, their conduct was within the protection of the Business Judgment Rule:

> [T]he fundamental issue presented by the business judgment rule is whether or not the defendants [bank directors] made honest and good faith judgments in the lawful and legitimate exercise of corporate purposes. If they did, without any evidence of fraud, bad faith or self-dealing, their actions are protected even if their judgment later turns out to have been wrong.[59]

A similar view was adopted by the Bankruptcy Court in *In re Xonics, Inc.* [60] This case involved a claim by creditors that the Chief Executive Officer (CEO) of Xonics Inc., breached his fiduciary duty to the insolvent corporation by negotiating an allegedly "ruinous" sale of a portion of corporate assets under which the CEO became an employee and director of the purchaser.[61]

The Bankruptcy Court evaluated the creditors' claims in accordance with principles similar to the Business Judgment Rule. In so doing, it focused on the CEO's full reporting to the Xonics board of all available sale options, the full disclosure of the offer of employment from the proposed purchaser, and the board's full assessment of these options, including a separate evaluation by independent directors and the advice of counsel.[62] The court concluded that, under those circumstances, neither the CEO nor the board breached any fiduciary duty:

> This court must be able to rely on officers' and directors' actions, even for an insolvent corporation unless those seeking damages show that such actions are venal. To require less in assessing breach of fiduciary duty on the Committee's [the creditor's] record in this case would constrain the commercial world in developing means to aid the floundering corporation.[63]

The judicial application of the Business Judgment Rule has not universally resulted in support for the conduct of directors of a corporation in the Zone. In two separate decisions, district courts have concluded that, while the Business Judgment Rule is the appropriate standard of care to be applied when evaluating director conduct in such situations, the Rule will not immunize from liability directors determined to have acted in their own self-interest.[64]

Conflicting Directive Obligations

Wieboldt Stores Inc. v. Schottenstein[65] involved allegations of self-interest on the part of the Wieboldt Board of Directors regarding a proposed leveraged buyout (LBO) of the insolvent corporation. The Wieboldt Corporation, on its own and on behalf of the unsecured creditors, instituted Chapter 11 proceedings and claimed, among other matters, that the Wieboldt board breached its duty to the unsecured creditors to preserve the corporation's assets "'by assisting in the formulation and completion of the LBO' despite Wieboldt's insolvency and knowing that the LBO would injure Wieboldt's unsecured creditors."[66] In other words, Wieboldt argued that it was the victim of the board's inferior management and, as result, its unsecured creditors suffered similar injury.[67]

The board argued that its conduct in considering and approving the LBO was protected by the Business Judgment Rule.[68] However, the court noted that, within the context of the pending takeover bid, such protection would apply "only if the board

'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.'"[69]

The court ultimately concluded that Wieboldt had indeed stated a claim for breach of fiduciary duty, notwithstanding the possibility that the board may have adequately investigated the terms of the LBO and anticipated its effects upon the corporation.[70] The court determined that the directors likely failed to act in good faith and in furtherance of the corporation's best interests.[71] Key facts supporting this conclusion indicated that four of the nine directors held Wieboldt shares prior to the tender offer, the remaining directors were associated with one of the corporation's two controlling shareholders, and the board approved the tender offer despite its concurrent knowledge that the corporation was insolvent. [72]

First Options of Chicago, Inc. v. Polonitza concerned a director-officer's approval of a transaction that forgave certain loans made by the corporation to his son by offsetting the loan against accrued and unpaid compensation.[73] The defendant, the President of Henry Polonitza Corporation, argued that the Business Judgment Rule provided an absolute defense to any claim of breach of fiduciary duty because he relied on the advice of counsel in approving the transaction.[74] In evaluating this defense, the district court noted that at least one court has held that the Business Judgment Rule is inapplicable to certain actions of an officer-director who might be liable for particular conduct because of his capacity as an officer, whereas ordinary directors would not be liable.[75] The district court concluded that, when the defendant unilaterally approved the transaction forgiving his son's loans, he did not act as a disinterested outside director on a business matter; therefore, the Business Judgment Rule would not apply to shield the transaction from scrutiny, even given the reliance upon advice of counsel.[76]

Clarkson Co. v. Shaheen[77] similarly added valuable guidance in the application of corporate law principles. *Clarkson* involved an action by a trustee in bankruptcy to recover over $30 million loaned by Newfoundland Refining Company Limited (NRC) to the defendant, Shaheen, and to a complex of corporations directly and indirectly controlled by him, of which NRC was a part.[78] In the jury instruction, the court applied principles of corporate law rather than trust law to describe appropriate director conduct toward creditors in the context of an insolvent corporation:

> [upon insolvency directors have] an affirmative duty to inform themselves about the affairs of the corporation . . . [and] a director may rely on information, opinions, reports or statements including financial data prepared by persons regarding matters which the director believes to be within the competence of such persons as long as the director is acting in good faith and with care in so doing.[79]

Accordingly, the court determined that there was sufficient evidence for the jury to have concluded that the corporation was "hopelessly insolvent" at the time the corporation engaged in a series of transactions with its controlling shareholders, and that the directors knew or should have known that the transactions both lacked consideration, and were entered into while the corporation was insolvent.[80]

V. What Constitutes Appropriate Director Conduct In the Zone?

Directors of corporations in or approaching the Zone and their counsel can glean some guidance on appropriate director conduct therein from some of the more recent cases considering the Insolvency Exception, regardless of whether a trust fund or Business Judgment Rule standard is applied.

The seminal *Credit Lyonnais*[81] decision provides a useful example of appropriate conduct by an officer-director within the Zone. In this case, the corporate management team of MGM elected to resist the efforts of the controlling stockholder to liquidate corporate assets in order to raise capital. The Delaware Chancery Court found that the management/board had not breached its fiduciary duty by "not immediately facilitating whatever asset sales were in the financial best interest of the controlling stockholder," because the management team/board carefully scrutinized the potential transactions and acted "in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity."[82]

Similarly, the court in the recent *Allied Riser* litigation[83] found the board entitled to Business Judgment Rule protection when, in electing to pursue a merger opportunity, it did so on the basis of advice of a financial advisor that the transaction would be "fair" to the corporate creditors—even if the transaction entailed some risk thereto (as long as the elements of the Rule [as to good faith and disinterest] were satisfied).

In re Xonics, Inc. is another of the few modern cases in which director conduct was determined to be consistent with the required standard of conduct. This case involved a potential "sweetheart deal" for an officer-director, fully disclosed to an independent board that discussed it and other potential transactions. There was no evidence of manipulation of the board by the implicated officer-director.[84]

In *Steinberg v. Kendig,*[85] the court found acceptable officer-director efforts to prolong the corporate life of an entity by "refreshing" or "redating" the due dates of accounts receivable beyond insolvency.[86] The *Steinberg* court upheld the lower court's determination that such actions failed to support a cause of action for breach of fiduciary duty, as the directors had a good-faith belief in the existence of an alternative to maximize the corporation's long-term wealth, and the complainants failed to allege fraud or self-dealing.[87]

Perhaps as could be expected, most of the Insolvency Exception cases provide guidance on how directors should *not* act during the Zone:

- The manipulation of assets, properties, and liabilities of a subsidiary (*eg.* mortgaging a subsidiary's property to secure and pay loans of the parent, canceling a sale and lease back transaction and repurchasing the property) for the *sole benefit of the parent.*[88]

- "An insider" – director approving a major transaction (*e.g.,* a leveraged buyout) that such director knew would benefit some or all of the directors and harm the corporation.[89]

- Forgiveness of debts to an insolvent corporation by improperly transferring corporate property or by making preferential payments.[90]

- Approving loans made by the corporation while it was insolvent and which were made without consideration and were approved by insider-directors.[91]

In light of current high-profile bankruptcy proceedings, the equity to creditors of the otherwise normal and customary practice of entering into retention arrangements with key corporate officials also may be called into question.[92]

VI. Are There Special Rules Applicable to Nonprofits?

Zone of Insolvency issues are particularly challenging for officers and directors of nonprofit corporations who have fiduciary roles that are often significantly more complicated than those faced by their for-profit counterparts. Nonprofit directors not only have an obligation to preserve and protect the charitable assets entrusted to them, which is analogous to the obligations of charitable trustees, but they also have a duty of obedience to the purpose to the mission of the corporation. These duties can, on occasion, be difficult to reconcile. This conflict between carrying out the charitable mission and protecting the possible interests of creditors may necessitate the filing of a bankruptcy petition in order to obtain court protection for any decisions made by the directors. Absent such a filing, the board could find its decisions challenged in competing legal actions filed by the attorney general on the one hand, and by creditors on the other—each seeking opposite decisions by the board.

Conflicting Directive Obligations

In the recent case of *Manhattan Eye, Ear, & Throat Hospital* (MEETH) *v. Spitzer*,[93] the directors of MEETH faced a potential conflict between these two duties. Well-respected investment bankers had advised the MEETH directors that the long-term financial prospects for the hospital were unfavorable, and that selling the organization's underlying real estate could maximize its charitable assets,—in essence "monetizing" the existing assets for future use.[94] The directors proposed to do this and to use the proceeds to operate clinics for the medically underserved in their community.[95] This plan was challenged by a lawsuit initiated by the New York Attorney General, various physicians at the hospital, several competing nonprofit hospitals, and the unions representing the hospital's employees.[96] In the lawsuit, the plaintiffs contended that the directors had an overriding obligation to continue the predominant purpose of the corporation, which was to maintain a nonprofit hospital, and could not properly sell the hospital's real property—even if such a sale would maximize the value of the corporation's assets.[97] The competing nonprofit hospitals offered to purchase the corporate assets and to continue the nonprofit hospital mission, albeit at a price substantially less than was offered by the real estate developer.[98]

In siding with the plaintiffs, the court ruled that the directors had violated their duty of obedience to purpose by voting to sell the assets and abandoning the predominant hospital purpose with-

out the benefit of a reasoned determination that the hospital could not have continued to operate as a nonprofit specialty acute care facility.[99] The court's decision did not expressly prohibit such a sale, but raised the procedural bar significantly.

The directors likely felt caught between their duty to preserve and protect the value of the assets under their control and their duty to continue the mission of operating a nonprofit hospital. This conundrum would only have been exacerbated had the hospital been within the Zone, with its debt owed largely to unsecured creditors. In this situation, a third duty, protecting the possible interest of the creditors, would have been added to the directors' burden. Assume that the amount offered by the developer was sufficient to pay all of the creditors' claims in full, while the nonprofit hospitals' offer to purchase and continue operations would have paid only twenty-five cents on the dollar. In such a situation, how would the court have balanced the competing interests? While the authors doubt the court would have precluded the sale in such a case, the legal principles involved create a potential for a conflict between the competing fiduciary duties.

Conflicting Directive Obligations

In fact, a situation of this type arose in the bankruptcy of Allegheny Health Education and Research Foundation (AHERF).[100] In AHERF, an eight-hospital system with a "supporting organization" as the sole corporate member and parent,[101] went into partial bankruptcy. Four hospitals and the parent filed for Chapter 11 protection, while four other system hospitals did not file and remained outside of the bankruptcy.[102] Moreover, due to the power of the parent to appoint board members of the affiliate independent hospitals, there were overlapping directorships, with the same individuals sitting on the boards of both bankrupt and nonbankrupt entities.

The Pennsylvania Attorney General challenged this board structure, asserting that the debtor-parent corporation should not have the authority to appoint board members of the nondebtor affiliates (notwithstanding reserved powers in the articles of incorporation to do so), because this constituted a conflict of interest.[103] The attorney general argued that the debtor entities and their boards had an obligation to attempt to protect the creditors' interests by upstreaming assets of the nondebtor affiliates. On the other hand, the attorney general argued that the directors of the nondebtor affiliates had a fiduciary duty to their corporations to preserve and protect those assets from the same creditors in order to carry out the charitable mission of the affiliates.

In addition, the attorney general challenged the right of the parent corporation to make any claim to the assets of the nondebtor affiliates. In essence, the attorney general argued that each independent corporation had an intrinsic charitable mission that superseded any obligation owed to the system—and that this was true as a matter of law. While the matter was resolved before a definitive answer could be obtained, the issues involved are relevant any time healthcare systems organized in this manner approach the Zone.

Another potential problem situation for hospital systems organized in a similar manner arises when, while caught in the Zone, they attempt to sell individual hospitals to repay system debts and return the system to solvency. A number of state attorneys general have taken the same position as the Pennsylvania Attorney General, and argued that the assets of the individually-incorporated nonprofit hospitals are impressed with a charitable trust separate and apart from that of the system. As such, those attorneys general have argued that the proceeds of such a sale must be placed in an endowment fund, subject to restrictions as to purpose or geographic use.

Once again, directors within such an organizational structure may find themselves in a compromised position. If they agree to such restrictions and take actions that remove assets from the reach of creditors, they may create liability exposure to such creditors. However, failure to accede to such conditions may either doom the deal or expose them to breach-of-trust allegations by the state attorney general. Clearly, finding one's nonprofit corporation within the Zone creates substantial legal issues that must be carefully evaluated.

VII. When Does a Corporation Enter the Zone of Insolvency?

A fundamental question in the entire analysis of director conduct is when the corporation enters the Zone. For a corporate board to be able to act in accordance with the applicable standard of care, it is *critical* that it be able to determine with some precision exactly when the shift in its duties may occur. However, as with so many other aspects of this legal concept, there is no black-letter definition of the Zone. Indeed, federal and state statutes themselves offer differing definitions of "insolvent" and "insolvency."[104] There does, however, appear to be a rather broad acceptance of the view that reliance on the formalities of bankruptcy is to be

avoided, and that instead there should be a focus on an evaluation of the corporation's assets and liabilities.[105]

Case law generally has applied one of two different tests for determining whether a corporation is insolvent: either the "Equitable Insolvency Test" or the "Balance Sheet Insolvency Test."[106]

Under the Equitable Insolvency Test, a corporation is determined to be insolvent when it is unable to pay its debts as they become due.[107] Some courts have expressed reluctance to apply this test, because it could lead to a premature dismissal of shareholder interests in cases in which a corporation encounters a sudden loss of liquidity due to financial market turmoil, or in which rapid technological change has created a swift decline in a corporation's asset value, yet the corporation still maintains adequate cash flow to pay its debts as they become due.[108]

Under the Balance Sheet Insolvency Test, a corporation is deemed insolvent when its total liabilities exceed its total assets.[109] Some courts have expressed a reluctance to apply this test, because of the various methods by which asset values may be assessed.[110]

The Balance Sheet Insolvency Test is illustrated by the seminal 1992 decision of the Delaware Court of Chancery in *Geyer v. Ingersoll Publications Co.*[111] This case involved claims of breach of fiduciary duty by the defendant director who allegedly entered into several transactions rendering the corporation insolvent and unable to satisfy a $2 million promissory note owed to the plaintiff.[112] The defendant argued that the Insolvency Exception did not affix to create fiduciary duties to creditors until the corporation had commenced bankruptcy proceedings, arguing that, without such a rule, "the transaction costs of running a corporation that was bordering on insolvency in fact would be overwhelming."[113] The court denied the defendant's motion to dismiss, concluding that fiduciary duties to creditors arise at the moment of insolvency, rather than the moment of the institution of statutory proceedings.[114]

The court's conclusion was based upon its interpretation of existing Delaware case law and the following policy considerations:

> An entity is insolvent when it is unable to pay its debts as they fall due in the usual course of business. That is, an entity is insolvent when it has liabilities in excess of a reasonable market value of assets held.

> . . . The existence of the fiduciary duties at the moment of insolvency may cause directors to choose a course of action that best serves the entire corporate enterprise rather than any single group interested in the corporation at a point when the shareholders' wishes should not be the directors' only concern. *Furthermore, the existence of the duties at the moment of insolvency rather than the institution of statutory proceedings prevents creditors from having to prophesy when directors are entering into transactions that would render the entity insolvent and improperly prejudice creditors' interests.*[115]

Other cases has expanded the definition of insolvency to apply the Insolvency Exception to situations in which the corporation is not yet insolvent, but rather is "in the vicinity of" or "on the brink of" insolvency. These cases appear to suggest that it would be inequitable to delay director consideration of creditor interests until the actual event of insolvency. Accordingly, the Insolvency Exception may apply in pre-insolvency situations where directors take certain actions, such as aggressive business decisions made principally to benefit the shareholders, which may unnecessarily place the interests of creditors and of the corporate enterprise at risk:[116]

Conflicting Directive Obligations

> At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers [the shareholders], but owes its duty to the corporation enterprise.[117] [I]n managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise where the right (both the efficient and fair) course to follow for the corporation may diverge from the choice the stockholders would make if given the opportunity to act.[118]

Another application of the Balance Sheet Insolvency Test was made by the court in the recent decision in *Allied Riser.*[119] The defendants had argued that, if the corporation's liabilities were valued at market value rather than face value, the corporation would be considered insolvent. The chancery court rejected this valuation approach and referred to the Balance Sheet Insolvency Test, under which the court concluded that the corporation was insolvent because its liabilities exceeded its assets.

A corporation may also be considered to be in the Zone if it enters into a transaction that leaves the corporation with an unreasonably-small capital base, making insolvency reasonably foreseeable. *In re Healthco*[120] involved a complex weave of bankruptcy-related cases instituted by a bankruptcy trustee related to the financial and fiduciary duty implications of a LBO transaction. Under the logic of the court, a board of directors of a solvent corporation may nevertheless owe a fiduciary duty to creditors if the directors knew, or should have known, that a course of corporate conduct, such as a LBO transaction which applies assets directly for the benefit of shareholders, would likely produce insolvency because the corporation would be left with an unreasonably-small capital base.[121]

VIII. The Solvency Analysis

As noted above, it is difficult to measure where the Zone begins, and the concept itself is inherently lacking in precision. In considering this issue, one should recognize that boards are confronted with circumstances that are fundamentally *economic* phenomenon, such as business downturns, which have the potential to cause *legal* difficulties like insolvency and bankruptcy, the resolution of which will depend on *accounting* information. As a result, a board is confronted with the need, at least in part, to utilize accounting data in a predictive fashion in order to be alert to any changes in its fiduciary obligations.

So what can boards do to be alert to this potential of moving into the Zone? Experience shows two areas that can be of great assistance:

- A rigorous and regular review of basic measures of the enterprise's financial and business health.
- Should potential concerns be identified, augment legal counsel with an independent financial advisory firm (*not* the corporation's auditors) in order to determine the value of the assets and assist in reviewing the strategic options available to the board. These options need to be understood *vis a vis* changing fiduciary duties.

What, then, are the pertinent financial measures? Classically, three major characteristics are used to assess the financial viability of a healthcare organization: *profitability*, *liquidity*, and *leverage*. These can be analyzed through the use of several financial ratios, which are calculated using historical data or forecasts of

the organization's future results. In addition to the financial data, facilities utilization data offer important insights into the financial health of the organization. Trends in the demand for services and the manner in which they are provided offer a means of explaining, in part, past financial performance. Expectations as to future performance will hinge importantly on financial projections that are driven by realistic financial and operational assumptions.

Profitability is the ability of the organization to sustain itself and to grow. Several ratios are most often relied upon to assess profitability. The *operating margin* is a key ratio; it measures operating income (total operating revenue less total operating expense) divided by total operating revenue. This tells the analyst just how effectively the organization's core business pays all the expenses that are essential to the operation. Similarly, *operating cash flow margin* shows how well the organization can convert revenue into cash. This ratio is the result of earnings before interest, depreciation, and amortization, divided by total operating revenue. A third ratio, *excess margin*, looks to the bottom line by adding to the operating margin the net non-operating revenue and dividing by total operating and non-operating revenue. Among healthcare organizations, non-operating revenue often consists primarily of investment income. This form of revenue is sometimes reported as operating revenue, thereby bolstering the operating margin.

Together, these ratios provide a litmus test, albeit on an historical basis, of the organization's ability to survive. Positive ratios mean that the organization is solvent with respect to the ordinary obligations of executing its fundamental business. An unprofitable operation will inexorably move the organization toward insolvency. These ratios do not explain, however, *why* profits are failing; they are merely a warning signal that something is wrong, or a confirmation that something is right.

Liquidity measures the ability of the organization to meet its obligations without having to liquidate the fixed or other assets on which the business itself depends. *Days of cash on hand* is a key ratio. The total amount of cash and investments that is not restricted for special purposes is divided by the daily cash operating expense. This tells us how long the organization can continue to pay its bills even if revenues fall to zero. Strong, growing cash and investment balances usually reflect a good operating margin and imply continued solvency, whereas unprofitable operations will eventually draw down unrestricted cash and move the

organization toward insolvency. Liquidity measures financial strength at a given point in time; it does not sustain itself, however. Profitability is the means of maintaining and improving liquidity over time.

Cash to debt is a related liquidity measure that compares total unrestricted cash and investments with the total amount of debt. It suggests how readily creditors' claims might be satisfied without liquidating fixed assets. Some organizations can pay off their entire debt and have cash left over, while others can only cover a portion of the debt. *Days in accounts receivable* reflects the ability of the organization to collect revenues from the services that it provides. It indicates the effectiveness of management's control of the payment process.

Leverage relates to the capital structure of the organization, which is reflected by the division between debt and equity. *Debt to capitalization* is a ratio computed by dividing the amount of debt by the total of debt plus equity. This ratio shows, at any point in time, the extent to which debt is used to place the organization's assets in service. The greater the leverage, the more creditors will be concerned about the margin for error in the profitability of the enterprise, and hence the adequacy of its capital.

Debt service coverage may be considered both a measure of leverage and a measure of profitability. This ratio is the result of earnings before interest, depreciation, and amortization divided by the annual, or maximum annual, debt service due on outstanding debt. The stronger the cash flow generated by the core business, the more certain will be the payments to creditors as obligations come due.

Debt to cash flow measures how long it would take to pay off the entire outstanding debt by the amount of earnings before interest, depreciation, and amortization. This tells us how long it would take to pay off the debt. This ratio places the debt in the context of the existing business and its ability to generate cash flow. If this ratio is increasing, and debt service coverage is declining, the organization is moving in the direction of insolvency.

Should a rigorous and regular review of these sorts of performance indicators suggest a potential decline in the enterprise, the board should take immediate action to ascertain the extent of the problems, the alternatives that may exist, and any legal exposure that the board, management, and the enterprise may experience

in the future. In such circumstances, the board should consider engaging legal counsel with extensive experience in bankruptcy matters and creditors' rights, and a financial advisory firm which has experience in valuing healthcare businesses as well as knowledge of capital formation matters, including bond issues. These professionals can assist the board and its managers in determining whether the enterprise is approaching insolvency, what options are legally and practically available to it under the circumstances, what the market value of its business is, and how that compares to its liabilities. Importantly, legal counsel can advise board members as to the changes that will occur in carrying out their fiduciary duties should the enterprise enter the Zone, and in the event that the enterprise actually becomes insolvent. The financial advisor is also able to advise the board and its managers as to the legal and practical obligations that it has to creditors, including bondholders, and other interested parties such as credit rating firms and bond insurers; the financial advisor can also develop a proactive strategy to address the concerns of these important constituents.

Valuation of the business enterprise is a central issue in identifying options that may be available to a business that is in the vicinity of insolvency. Ascertaining the enterprise value will help determine whether the true value of the assets exceeds the value of the liabilities. Additionally, the exercise, as will be described in detail, will force the organization to assess candidly the future operating performance of the hospital.

Like beauty, value is often in the eye of the beholder. The process of determining in a rational way what a certain asset, group of assets, or company is worth is an inherently ambiguous exercise requiring considerable judgment. This is particularly true when one is attempting to measure value in the context of the Zone. Insolvency is a legal matter that turns, in part, on imprecise and varying economic definitions of the concept. In many cases, courts appear to view insolvency as turning on an enterprise's "assets less its debts," or balance-sheet-related information. In other cases, courts seem to focus on the ability to pay debts, or income-statement-related information. As a result of this ambiguity, it is particularly important for the board to be well-apprised of the hospital's value in relationship to its long-term debt.

Valuation may encompass several distinct but closely interrelated concepts. None of the valuation tools is inherently better than the others, and each method is used in different circumstances. While most valuation work is done within the frame-

work of a specific transaction or circumstance, one should also be aware of how others will perceive the value of the property in question and how market forces could affect the price at which an asset or company will clear the market.

The two primary valuation concepts used are *intrinsic financial value* and *acquisition value*. Two other valuation concepts, *liquidation value* and *replacement value*, are sometimes considered in circumstances where assets are important factors.
Intrinsic financial value captures the discounted present value of the free cash flows generated by the assets of a business as a going concern, plus a terminal value of the business, also discounted to the present at an appropriate discount rate. Intrinsic valuation looks at a time series of financial flows over a certain period and attempts to estimate what a purchaser would pay for these cash flows from a purely financial point of view. The discounted cash flow (DCF) methodology used to arrive at this value is necessarily predicated on a series of assumptions about the nature of the cash flows and a judgment as to the appropriate rate at which to discount these flows. The intrinsic value of the company, therefore, changes as the assumptions from which the forecasts are generated or discounted are changed. As is true in most analyses, a DCF valuation is only as good as the assumption or projections on which it is based.

Acquisition value seeks to estimate the price at which the company would trade in the market for corporate control; this means the price an acquirer would pay to control the target's assets and the free cash flows they generate. The acquisition value of a company may differ significantly from its intrinsic financial value. Acquisition valuation is perhaps less theoretical and more concerned with the real world than DCF valuation. The value of a company in the market for corporate control usually is higher (and often very much higher) than its value in the secondary trading market. Classically, there are two approaches to determining acquisition value: (1) current stock market trading levels or, for a private company, an estimate of where it would trade in the public market if it were publicly traded; and (2), an analysis of acquisition precedents, or the record of comparable transactions. Estimates of value based upon where an enterprise would trade in the public market usually can be made easily, and within reasonably tight parameters, by comparison with similar public companies and by analyzing the financial and business characteristics of the property in question. With regard to acquisition precedents, one is looking at price as a multiple of certain financial measures. The most commonly-used measures are earnings, book value, and

cash flow. A fundamental assumption of this analysis is that companies in the same industry share common characteristics that should be reflected in their acquisition valuation. For the hospital industry, multiples of cash flow and, to a lesser extent, net revenues are most frequently utilized.

Liquidation value is an estimate of the net proceeds associated with selling the assets of the company at their fair market value and satisfying all liabilities. Liquidation value often represents a minimum value for a business combination transaction. *Replacement value* is an estimate of duplicating the company's assets at current costs, and is sometimes useful in a merger transaction in which a potential buyer is viewing the acquisition as an alternative to entering the business by internal expansion.

In the end, even when armed with the results of various analyses such as DCF values, secondary market trading levels, a history of comparable transactions, and estimates of liquidation or replacement values, the evaluator moves from the arena of seeming precision and science to the realm of judgment and art. The knowledge of certain intangible factors, the ability to use this knowledge, imagination, and creativity enable one to elevate valuation from a science to an art. Also, one must be wary of any distortion in the financial statistics used in the type of calculations described above. Examples of such distortions include differing accounting conventions, cyclicality, and financial leverage. Ultimately, the ability either to affect the eyes of the beholder and what these eyes perceive as value, or to find the right eyes, is a skill that is based on the results of analysis but goes beyond the pure mechanics of analysis.

IX. Practical Observations and Recommendations

Recognizing the existence of the Insolvency Exception, the question then becomes what steps should senior management—and the board—of a financially-distressed healthcare corporation pursue to position the board to be responsive to creditor concerns should the corporation enter the Zone.

A. Before Problems Arise

1. Re-evaluate the corporation's organizational structure to avoid potential conflicts of interest. The issues considered should include eliminating overlapping boards and re-thinking the "tail

wags the dog" organizational structure in favor of a unified corporate structure with a single fiduciary board.

2. For those organizations with independent affiliated system members:

> (a) Conduct a review of the articles of incorporation and bylaws of each affiliated corporation to insure that "system-favorable" articles and bylaws are in place, including specific provisions that make support of the system and system-wide initiatives an explicit purpose of the affiliate corporations.
>
> (b) Adopt accounting procedures that ensure that advances or subsidies of unprofitable independent affiliates are carried on the system books as loans. In the regard, the system will be a legitimate creditor of the affiliate in the event of a future bankruptcy or sale of the affiliate in which the state attorney general attempts to impose a restricted trust on sale proceeds.

3. Ensure that a reasonably clear, plain English, but informative financial summary is included as an agenda item for each meeting of the board of directors. Adopt a no-surprise policy with respect to adverse financial developments.

4. Adopt corporate governance policies designed to encourage open communication between members of the senior leadership team and the board, to reduce the potential for financial managers to decline to pass along negative financial information because of fear of executive retribution.

B. After Problems Arise

1. The authors believe that members of the senior corporate leadership team, particularly financial managers, have a shared responsibility to advise the board of directors not only of the corporation's financial condition relative to insolvency, but also of the board's shifting fiduciary duties once the corporation has entered the Zone. To be sure, the board has a fundamental fiduciary obligation for the management of the corporate enterprise, to exercise its duties of care and loyalty, to make inquiry, and exercise appropriate diligence as part of rendering informed decisions. Nevertheless, in so doing the board is, of course, entitled to rely on the reports and advice of management and of experts retained by management in the board's exercise

of its fiduciary duty. A board cannot, however, reasonably be expected to be aware of the Insolvency Exception and its ramifications, or even to be able to make an informed evaluation of whether the corporation is in, or is nearing, the Zone, absent the advice and guidance of its senior management. Absent such guidance, it is entirely possible that a well-intentioned board of a healthcare corporation, generally mindful of its normal fiduciary obligations, could innocently proceed into the Zone, make corporate decisions therein without any specific regard to the corporate enterprise in general and corporate creditors in particular, and thus subject themselves to significant exposure for breach of fiduciary duty claims subsequently brought by creditors of the corporation. Query whether the typical corporate directors' and officers' liability insurance coverage would offer protection in such a situation. Realistically, senior management must assume the responsibility for advising the board of Insolvency Exception issues. Corporate general counsel of a financially-distressed healthcare counsel, aware of the potentially precarious financial condition of the corporation, may prudently advise his executive and financial colleagues of the existence of the Insolvency Exception, its impact on director duties, and related impact on corporate decision-making. General counsel could also prudently advise the chief financial officer of the various measurements for determining insolvency—the key ratios described herein, maintaining an updated "valuation," and any credit watch or downgrade—which could be used to track against the corporation's financial condition. Any such tracking should be done on a recurring basis. Given the application of the Insolvency Exception to board actions while the corporation is in the Zone, and the inherently "slippery" nature of defining when a corporation actually enters the Zone, the senior management team should not tarry in its obligation to advise the board of directors. In this regard, the senior leadership team or, ultimately, the board of directors, is well-advised to engage the services of an outside financial advisor to track for it corporate financial condition and value against insolvency standards, enabling the board to have access to independent financial advice free from the potential conflict of interest of (and undeniable pressure on) the corporation's financial manager.

2. Boards of directors of nonprofit organizations should obtain and document advice from the corporation's general counsel and/or outside counsel with respect to compliance with their fiduciary duties in dealing with charitable assets while in the Zone. These are extremely complicated issues and most nonprofit statutes provide specific protections for directors who rely on

such advice, immunizing them from personal liability if they reasonably rely on such advice.[122]

3. When considering a major corporate transaction while operating in the Zone, the board should rely upon the advice of competent financial advisors, who would evaluate the impact of the proposed transaction on the creditors and (depending upon the jurisdiction) the entirety of the corporate enterprise.
4. Boards should also consult bankruptcy counsel to see whether the protection of the bankruptcy court is advisable prior to making any key decisions. In this regard, it is important to note that the complainants in bankruptcy court likely will be large creditors, formal and informal creditors' committees that are all well-represented by counsel, the United States Trustee's Office (which is an arm of the Department of Justice), and Chapter 7 or 11 bankruptcy trustees seeking to return dollars to creditors—with all such complaints being heard by a bankruptcy judge, who is likely to be creditor-friendly. One should consider the comparison to the normal breach-of-trust matter, where standing to pursue relief is largely limited to the attorney general or dissident officers and directors, and where the forum is the more neutral state trial court.

5. Corporate counsel should be particularly attentive to solvency issues when the organization has retained a corporate workout or turnaround team. In such a situation, the focus of the turnaround firm is likely to be on matters of efficiency and profitability, and not directly on monitoring levels of solvency. Corporate counsel may need to serve as a liaison between the turnaround firm, the remaining members of the financial management team, and the board of directors with respect to the Zone.

6. Boards should consult with local attorneys general or other state regulators. Where difficult questions arise that impact charitable assets, state attorneys general normally appreciate a no-surprises policy. This will allow the corporation to work through potential problems with the attorney general or, at a minimum, identify the extent of such problems before taking action. Of crucial importance: It is generally preferable to be a plaintiff in a declaratory relief lawsuit seeking court instruction as to the best way to proceed in the face of a dispute with the attorney general than to find oneself a defendant in a breach-of-trust action filed by the attorney general.

Endnotes

[1] Such financing relationships include provider/vendor, parent/subsidiary, the provider as a financial guarantor to other entities such as physician groups, and joint venture financing arrangements.

[2] Moreover, the application of Zone of Insolvency issues applies in *all* industries, not just healthcare.

[3] Nonprofit corporate directors also are charged with a duty of obedience to the corporate mission, which requires essentially that they act in a manner which they reasonably believe to be consistent with the charitable mission of the corporation.

[4] In many commercial states, the development of nonprofit corporation law has closely followed the development of statutes dealing with business corporations. Indeed, the drafters of the American Bar Association's (ABA's) Revised Model Nonprofit Corporation Act specifically determined to parallel the Revised Model Business Corporation Act, except for those situations in which the nature of nonprofit corporations or public policy considerations related thereto dictated otherwise. Lizabeth A. Moody, *The Who, What, and How of the Revised Model Nonprofit Corporation Act*, 16 N. Ky. L. Rev. 251, 256 (1989).

[5] ABA, Revised Model Nonprofit Corp. Act § 8.30(a) (1987).

[6] 1984 Model Business Corp. Act § 8.30(b) (1984, incorporating changes through Oct. 1999).

[7] Revised Model Nonprofit Corp. Act § 8.30(b) (1987).

[8] *Id.* § 8.30(c).

[9] *Id.* § 8.30, cmt. 2.

[10] *Id.*

[11] *Id.* § 8.30, cmt. 4.

[12] Guidebook for Directors of Nonprofit Corporations 28 (George W. Overton ed., 1993).

[13] Daniel L. Kurtz, Board liability: Guide For Nonprofit Directors 59 (1988).

[14] *Beard v. Achenbach Mem'l Hosp. Ass'n,* 170 F.2d 859, 862 (10th Cir. 1948); *Yarnall Warehouse & Transfer Inc. v. Three Ivory Brothers Moving Co.,* 226 So. 2d 887, 890-91 (Fla. Dist. Ct. App. 1969).

[15] Revised Model Nonprofit Corp. Act § 8.30, cmt. 3 (1987); Michael W. Peregrine & James R. Schwartz, *The Business Judgment Rule and Other Protections for the Conduct of Not-for-Profit Directors*, 33 J. Health L. 455, 459 (2000).

[16] Dennis J. Block et al., The Business Judgment Rule: Fiduciary Duties of Corporate Directors 5 (5th ed. 1998).

[17] *See* Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems and Proposed Reforms,* 23 J. Corp. L. 631, 643 (1998). *See also* Peregrine & Schwartz, *supra* note 15, at 460.

[18] Revised Model Nonprofit Corp. Act § 8.30 cmt. 3 (1987).

[19] *Burt v. Irvine,* 47 Cal. Rptr. 392, 406-08 (Ct. App. 1965); *Johnson v. Johnson,* 515 A.2d 255, 264 (N.J. Super. Ct. Ch. Div. 1986).

[20] *Burt,* 47 Cal. Rptr. at 406-08; *Johnson,* 515 A.2d at 264.

[21] *Burt,* 47 Cal. Rptr. at 406-08 (quoting *Casey v. Woodruff,* 49 N.Y.S.2d 625, 643 (Sup. Ct. 1944)).

[22] *Id.* at 407.

[23] Block, *supra* note 16, at 5.

[24] *Geyer v. Ingersoll Publications Co.,* 621 A.2d 784, 787, 791 (Del. Ch. 1992).

[25] Block, *supra* note 16, at 597.

[26] *Steinberg v. Kendig (In re Ben Franklin Retail Stores, Inc.),* 225 B.R. 646, *653 (Bankr. N.D. Ill. 1998) (*citing Geyer v. Ingersoll Publications Co.,* 621 A.2d 784 (Del. Ch. 1992)), *aff'd. in part and rev'd in part,* No. 97C7934, 2000 U.S. Dist. 276, at *1 (N.D. Ill. Jan. 11, 2000).

[27] Martin J. Bienenstock & Robert L. Messineo, *Financial Woes Affect Directors' Roles; Fiduciary Duties May Change to Include Responsibilities to Creditors,* N.Y.L.J., Oct. 22, 2001, at 13.
[28] *Steinberg v. Kendig (In re Ben Franklin Retail Stores, Inc.), supra* note 26.
[29] *Id.* at *654.
[30] *Id.*
[31] *Id.* (*citing Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.,* 1991 WL 277613 (Del. Ch. Dec. 30, 1991))(emphasis added).
[32] *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.,* 1991 WL 277613 (Del. Ch. Dec. 30, 1991).
[33] *Id.* at n.55.
[34] Block, *supra* note 16, at 596; *see Bank Leumi-Le-Israel v. Sunbelt Indus. Inc.,* 485 F. Supp. 556, 559 (5th Cir. 1997);*Federal Deposit Ins. Corp. v. Sea Pines Co.,* 692 F.2d 973, 977 (4th Cir. 1982).
[35] *See* Bienenstock & Messineo, *supra* note 27, at 13.
[36] *Id.* at 13.
[37] 692 F.2d 973 (4th Cir. 1982). *See First Options, Inc. v. Polonitza,* No. 88-C-2998 1990 WL 114740, at *4 (N.D. Ill. July 31, 1990); *Hovis v. Powers Construction Co. (In re Hoffman Associates, Inc.),* 194 B.R. 943, 964 (D.S.C. 1995); *see also Alexander v. Hillman,* 296 U.S. 222, 240 (1935).
[38] *Sea Pines, supra* note 34, at 977 (quoting *Davis v. Woolf,* 147 F.2d 629, 633 (6th Cir. 1945)).
[39] *Id.* at 977.
[40] No. 88-C-2998 1990 WL 114740, at *4 (N.D. Ill. July 31, 1990).
[41] *Id.* (emphasis added).
[42] *Creditors of Xonics Med. Sys., Inc. v. Haverty (In re Xonics, Inc.),* 99 B.R. 870 (N.D. Ill. 1989).
[43] *Id.* at 872 (emphasis added).
[44] *Gans v. MDR Liquidating Corp.,* No. 9630, 1990 Del. Ch. LEXIS 3 at *1 (Del Ch. Jan. 10, 1989).
[45] *Id.* at *24.
[46] *Id. See Sanford Fork & Tool Co. v. Howe, Brown & Co.,* 157 U.S. 312 (1895).
[47] Kurtz, *supra* note 13, at 22.
[48] *Id.*
[49] *Id.*
[50] 110 N.E.2d 397, 398 (N.Y. 1953).
[51] *Id.* at 399.
[52] *Id.* at 400.
[53] *Id.*
[54] C.A. No. 19298 (Del. Ch. Jan. 30, 2002).
[55] *Id. See* Allen M. Terrell, Jr. & Andrea K. Short, Directors' Duties in Insolvency: *Lessons from* Allied Rises, BNA Corp. Gov. Rep., Apr. 1, 2002.
[56] *Curiale v. Reissman,* 609 N.Y.S.2d 777 (App. Div. 1994) (unanimously affirming case for the reasons stated by Judge Shainswit). For the text of Judge Shainswit's opinion, see N.Y.L.J., July 6, 1993, at 31(col.2). *See also* Alan Kohn, *Judge Dismisses Claim Against Bank Officers; Personal Liability for Interest Ruled Out,* N.Y.L.J., July 6, 1993, at 1 (reviewing the court's use of the Business Judgment Rule's good faith judgment determination when assessing director liability).
[57] N.Y.L.J., July 6, 1993, at 31(col.2).
[58] *Id.*
[59] *Id.*
[60] *In re Xonics, Inc., supra* note 42.
[61] *Id.* at 872.
[62] *Id.* at 873, 876.
[63] *Id.* at 876.

[64] *See First Options of Chicago v. Polonitza*, No. 9449, 1990 U.S. Dist LEXIS 9449 at *1, *12-14 (N.D. Ill., July 31, 1990); *Wieboldt Stores v. Schottenstein*, 94 B.R. 488, 509 (N.D. Ill. 1988).
[65] 94 B.R. at 496.
[66] *Id.* at 507 (citing the complaint).
[67] *Id.* at 508.
[68] *Id.* at 488, 507.
[69] *Id.* at 509 (quoting *Unocal Corp. v. Mesa Petroleum*, 493 A.2d. 946, 954 (Del. 1985)).
[70] *Wieboldt Stores*, *supra* note 64, at 510.
[71] *Id.*
[72] *Id.*
[73] 1990 U.S. Dist. LEXIS 9449, at *12.
[74] *Id.* at *1, *12-13; CAL. CORP. CODE § 309 (Deering 2001)
[75] 1990 U.S. Dist LEXIS 9449, at *14 (citing Gaillard v. Natomas Co., 256 Cal. Rptr. 702, 711 (Ct. App. 1989)). *See* CAL. CORP. CODE § 309; WITKIN SUM. CAL. LAW CORP. § 110(2)(b) (9th ed. 2001) (reviewing authoritative analyses on negligence, mismanagement, and fraud liability of directors and officers).
[76] *First Options*, *supra* note 64, at *15.
[77] 660 F.2d 506 (2d Cir. 1981).
[78] *Id.* at 508.
[79] *Id.* at 512.
[80] *Id.* at 513.
[81] Credit Lyonnais Bank v. Pathe Communications Corp., No. 12150, 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991).
[82] *Id.* at *109.
[83] C.A. No. 19298 (Del. Ch. Jan. 30, 2002).
[84] *Creditors of Xonics Med. Sys., Inc. v. Haverty In re Xonics, Inc.*, *supra* note 42.
[85] 2000 U.S. Dist. LEXIS 276, *1 (N.D. Ill. 2000).
[86] *Id.* at *6-14.
[87] *Id.* at *11-14.
[88] *See Sea Pines Co.*, *supra* note 34.
[89] *See Wieboldt Stores v. Schottenstein*, *supra* note 64.
[90] *See First Options, Inc. v. Polonitza*, No. 88-C-2998 1990 WL 114740, at *4 (N.D. Ill., July 31, 1990)
[91] *See Clarkson Co. v. Shaheen*, 660 F.2d 506 (2d Cir. 1981).
[92] *See* Amy Merrick, *K-mart Officers Got Big Loans Before It Filed For Chapter 11*, WALL ST. J., Apr. 17, 2002, at B-1.
[93] 715 N.Y.S.2d 575 (Sup. Ct. 1999).
[94] *Id.* at 580-81.
[95] *Id.* at 581-82
[96] *Id.* at 586-88.
[97] *Id.* at 592; NY NOT-FOR-PROFIT CORP. LAW § 511(d) (McKinney 2001).
[98] *MEETH*, 715 N.Y.S.2d at 588-91.
[99] *Id.* at 595-97.
[100] *In re* Bankruptcy Appeal of Allegheny Health, Education and Research Foundation (AHERF), 252 B.R. 309 (Bankr. W.D. Pa. 1999).
[101] The authors refer to this organizational structure as the "tail wags the dog" model. Virtually all of the system assets are held in independent nonprofit corporations, while control is maintained in the parent entity whose role is to support its affiliates. This structure is largely a function of tax law; while it may work in that narrow context, it creates significant charitable trust law issues and potential liability exposure for the directors of the affiliate corporations.
[102] *AHERF*, *supra* note 100, at 313-14.
[103] *Id.* at 314-15.

[104] *See, e.g.,* 11 U.S.C. § 101(32)(A) (2001) (defining "insolvent" as a "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation"); UNIF. FRAUDULENT TRANSFER ACT § 2(a) (1984) ("[a] debtor is insolvent if the sum of the debtor's debts is greater than all of the debtor's assets at a fair valuation"); *id.* § 2(b) ("[a] debtor who is generally not paying his [or her] debts as they become due is presumed to be insolvent"); DEL. CODE ANN. tit. 6 § 1302(a) (2001) ("[a] debtor is insolvent if the sum of the debtor's debts is greater than all of the debtor's assets, at a fair valuation").

[105] *See, e.g.,* Thomas A. Califano, *A Shift in Fiduciary Duties: When A Corporation Approaches Insolvency, its Directors Owe Responsibilities to Creditors,* NAT'L L.J., Sept. 17, 2001, at B16.

[106] *Id.*; Bienenstock & Messineo, *supra* note 27, at 13.

[107] Califano, *supra* note 104, at B16.

[108] Bienenstock & Messineo, *supra* note 27, at 13.

[109] *Id.*

[110] *Id.*

[111] 621 A.2d 784 (Del. Ch. 1992).

[112] *Id.* at 785-86.

[113] *Id.* at 787.

[114] *Id.* at 789-90.

[115] *Id.* at 789 (citations omitted) (emphasis added). *See Bovay v. H.M. Byllesby & Co.,* 38 A.2d 808 (Del. 1944) (suggesting the fact which creates the trust for benefit of creditors is the insolvency, and when that fact is established the trust arises—the legality of the acts thereafter performed will be decided by very different principles than in the case of solvency).

[116] Bienenstock & Messineo, *supra* note 27, at 13.

[117] *Credit Lyonnais Bank v. Pathe Communications Corp.,* No. 12150, 1991 Del. Ch. LEXIS 215, at *108 (Del. Ch. Dec. 30, 1991).

[118] *Id.* at n.55.

[119] *Allied Riser, supra* note 83.

[120] *Brandt v. Hicks, Muse & Co.,* Inc. (*In re Healthco Int'l, Inc.*), 208 B.R. 288, 302 (Bankr. D. Mass. 1997).

[121] *Id.* at 302. *See also* Bienenstock & Messineo, *supra* note 27, at 13.

[122] *See, e.g.,* CAL. CORP. CODE § 5231 (2001).