

Directors of Bankrupt Hospital Could Be Liable

By Meg McEvoy

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- Officer and director negligence, malfeasance allegedly caused bankruptcy of nonprofit community hospital in Cheboygan, Mich.
- Community hospitals increasingly struggling; individual officers and directors can be held liable

A federal bankruptcy court refused to dismiss claims against a failed community hospital's former officer and directors for actions that allegedly led to the hospital's collapse.

The U.S. Bankruptcy Court for the Eastern District of Michigan said Aug. 2 it wouldn't dismiss claims for breach of fiduciary duty and malfeasance by a former officer and directors of Cheboygan Memorial Hospital. The court did dismiss claims against most of the directors under state laws that confer immunity to nonprofit volunteer directors.

The complaint, filed on behalf of the bankruptcy estate, alleged that the officers and directors failed to address losses and other financial issues that caused the hospital to fail.

According to the Polsinelli Health Care Services Distress Research index, which tracks bankruptcy filings for companies with more than \$1 million in assets, health-care bankruptcies for the first quarter of 2018 surged 270 percent over the same quarter last year.

As more community hospitals struggle financially and declare bankruptcy, concerns are deepening over the duties of their officers, directors, and boards and whether they can be held individually liable for fiscal woes.

"What's positive about a case like this is it makes us all again remember that serving on a board, we don't do that as a do-gooder," Stephanie Winer Schreiber, a shareholder in Buchanan Ingersoll & Rooney's health-care practice in Pittsburgh, told Bloomberg Law. "We have a legal responsibility when we serve on a board, and it's important to understand that that brings with it certain obligations."

The case will be one to watch on nonprofit boards' obligations going forward, Schreiber said.

Claims Against Individuals

CMH, a nonprofit community hospital in Cheboygan, Mich., filed for Chapter 11 bankruptcy in 2012. As part of the plan of liquidation, all of CMH's claims against its former officers and directors were assigned to the bankruptcy trust. In 2014, the trust brought claims against 32 of CMH's former officers and directors, alleging that their breach of fiduciary duties resulted in operating losses from 2008 to 2011 totaling \$16.4 million.

Bankruptcy trusts frequently sue former directors and officers as part of an effort to reclaim funds for the bankruptcy estate, Cecily A. Dumas, a bankruptcy partner with Pillsbury Winthrop Shaw Pittman in San Francisco, told Bloomberg Law. The lawsuits seek to hold former officers and directors liable under D&O insurance policies.

The court found the trust had stated a claim against CMH's former interim CEO, Brian Dietz, for breach of fiduciary duty and negligence for failing to address billing and coding issues. Other allegations against Dietz were dismissed because the trust didn't sufficiently allege he had the power to control losses due to physician practice pay levels.

The court dismissed claims against the other nonboard member officers. The court reasoned that several of the officers did not have the authority to make decisions without board approval.

Volunteer Director Defense

Several former members of the board had strong allegations against them, the court found, but they could not be found liable because they were volunteer directors.

The members of the board who oversaw the sale of CMH's interest in a home health service company joint venture called VitalCare in 2009 for less than fair market value could be liable for breach of fiduciary duty and negligence, the court said. Three directors and board members could be liable for malfeasance or nonfeasance, the court found.

Board member Susan Eno could be liable for a conflict of interest because she served on CMH's board while also acting as president of Citizens Bank when CMH refinanced \$4.3 million in long-term debt with the bank, the court found.

It is possible that several of the directors did not act in the best interests of CMH, the court found, because after March 2009, they allowed the hospital to continue to make monthly payments to Citizens, as they knew the bank was under-secured and at risk of losing money if CMH defaulted on its long-term debt.

But, because the directors were volunteers, they are immune under state laws that allow nonprofit corporations to exempt volunteer directors from individual liability, the court found.

The court did allow claims against Eno to go forward, since it was possible she received a financial benefit through her affiliation with Citizens Bank.

"This is an important yet complex case that addresses issues of breach of fiduciary duty, availability of the business judgment rule and the strength of state law grounded exculpatory clauses in the context of challenging facts," Michael Peregrine, a partner with McDermott Will & Emery in Chicago, told Bloomberg Law. Peregrine, who counsels health-care clients on corporate governance issues, also is a Bloomberg Law advisory board member.

Varnum LLP in Grand Rapids, Mich., represented the CMH Liquidating Trust.

The case is CMH Liquidating Tr. v. Anderson (In re Cmty. Mem'l Hosp.), 2018 BL 276340, Bankr. E.D. Mich., No. 12-20666, adversary proceeding 14-02020, 8/2/18.

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