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The Duties of Board Members in Potentially Distressed Organizations

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This article is part three in a series on the importance of hospitals and health systems assessing their strategic risk profile. Part one provided a framework for evaluating risk¹ and part two covered quantifying risk and identifying signs of stress in your organization.² The final article in this series will explore options for distressed organizations.

Board members of small community hospitals, whether organized as municipal hospitals or non-profit corporations, are generally subject to the same legal standards applied to board members in for-profit corporations with additional duties prescribed by statute. For instance, in North Carolina, board members of municipal hospitals are held to a heightened statutorily mandated duty of loyalty, reflecting the importance of effective governance across different hospital settings. Accordingly, because individual board members are fiduciaries of the organization, their duties include the duty of care, the duty of loyalty, and the duty of obedience. This article highlights each of these duties and steps boards can take to ensure they are effectively governing when their organization is potentially distressed.

The Duty of Care: Making Informed Decisions and Providing Oversight

The duty of care requires that board members act “with the care a person in a like position would reasonably believe appropriate under similar circumstances.”³ Comments to the Model Business Corporation Act (MBCA) indicate that what a director would “reasonably believe” is both subjective and objective in character. The subjective

- 1 Jeff Sommer, Jennifer B. Lyday, and Clare Kelley, “Proactively Assessing Your Organization’s Strategic Risk Profile,” The Governance Institute, *Rural Focus*, December 2023.
- 2 Jeff Sommer and Clare Kelley, “Quantifying Risk and Identifying Signs of Stress in Your Organization,” The Governance Institute, *Rural Focus*, April 2024.
- 3 Model Business Corporation Act (MBCA) § 8-30(b). The MBCA is a model act promulgated and periodically amended by the American Bar Association Business Law Section’s Corporate Laws Committee. The MBCA or significant portions of it has been adopted in 36 states including West Virginia, Virginia, North Carolina, Georgia, Alabama, Florida, Mississippi, Arkansas, Tennessee, and Kentucky.

element considers what a particular director genuinely believes in good faith.⁴ The objective element centers around the concept of “reasonableness,” specifically whether a reasonable person, with similar knowledge and experience, could have arrived at the same belief under the circumstances.⁵

This duty includes two essential obligations: to make informed decisions and provide reasonable oversight. These obligations require board members to take reasonable steps to oversee and be informed about hospital activities. Therefore, board members in a potentially stressed organization should insist on regular reports monitoring the market position, margins, revenue, cash flow, and resources of the hospital and act quickly upon any belief of mismanagement or illegal dealings. While the courts of virtually every state shield the actions of directors through the business judgment rule,⁶ failing to take reasonable steps to oversee hospital activities could lead to personal liability for board members.

In the context of a potentially stressed organization, board members should remember that ensuring that a “reasonable information and reporting system exists” is critical. For example, in the *Caremark* case,⁷ a complaint alleged that board members had “allowed a situation to develop and continue, which exposed the corporation to enormous legal liability” related to alleged violations by employees of federal and state laws regulating healthcare providers.⁸ In a decision followed by most courts, the Court of Chancery of Delaware held that directors can be liable for breaching the duty of care when there is “a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists....”⁹ This ruling serves to remind board members, especially in a potentially stressed organization, of the importance of implementing monitoring systems and investigating red flags indicating corporate misconduct.

The Duty of Loyalty: Acting in the Organization’s Best Interests

The duty of loyalty requires that board members act in the best interests of the organization.¹⁰ This means that a board member must act in good faith and without self-interest when making decisions for a potentially stressed organization. The duty of loyalty includes a board member’s obligation to avoid impermissible conflicts of interest. While conflicts of interest are often unavoidable, the law in most states provides a procedure for ensuring compliance with the duty of loyalty. These conditions generally include:

1. Giving the other board members notice of the conflict
2. Disclosing the nature of the adverse interest
3. Deliberating and voting without the conflicted board member present

4 MBCA, comment to §8-30(a).
5 *Ibid.*
6 The business judgment rule provides that a director will not be held personally liable if they made an informed decision, in good faith, without self-interest, and in the corporation’s best interests.
7 *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).
8 *Ibid.* at 967.
9 *Ibid.* at 971.
10 See MBCA § 8-30(a); § 8-42(a) (requiring directors to act in best interest of corporation).

Therefore, board members in all organizations should adopt and follow a conflict-of-interest policy.

In North Carolina, for example, board members of a municipal hospital have a heightened statutorily mandated duty of loyalty.¹¹ This heightened duty of loyalty requires that no member of the board, employee, or spouse of a member of the board or employee have any interest in the hospital facility, property, contracts, or proposed contracts.¹² Accordingly, board members of a potentially distressed organization, especially a potentially distressed municipal hospital in North Carolina, should be cautious of conflicts of interest where the organization may be seeking the advice of outside legal counsel and accountants.

The Duty of Obedience: Honoring the Organization's Mission

The duty of obedience requires board members to ensure that the organization is acting in furtherance of the defined purpose and mission as outlined in the corporate charter and bylaws. In most municipal hospitals, the defined purpose will be to improve the health of the people in the community. Board members have a fiduciary duty to consider the purpose of the organization even when facing insolvency. In a potentially distressed organization, board members must address operational and financial issues while balancing the organization's mission with the need to preserve patient care.

Action Items for Board Members

Unlike in other industries, the unique nature of healthcare services complicates the process of navigating a potentially distressed organization, requiring careful contingency planning for potential closure while ensuring regulatory compliance and patient welfare. To address these challenges effectively, board members are encouraged to take the following steps aimed at enhancing governance and ensuring organizational resilience:

- 1. Establish regular reporting mechanisms to monitor key financial and operational indicators** such as market position, margins, revenue, and cash flow. This can be done by requiring management to provide comprehensive reports at board meetings that highlight any areas of concern or potential mismanagement. It is essential to provide board members with five-year or longer trend analysis in addition to standard comparison to prior year and budget analysis to provide insight into key long-term trends. Board members should act promptly on any red flags identified during these reviews.
- 2. Ensure that the board has a conflict-of-interest policy.** If not, the board should develop a clear conflict-of-interest policy outlining procedures for disclosing and

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¹¹ See N.C. Gen. Stat. § 131E-14.2 (a) (1)-(2).

¹² *Ibid.*

managing conflicts among board members and employees. Board members should be educated on the policy and take steps to ensure compliance.

- 3. Align operational decisions with the organization's mission**, especially during times of financial distress. Board members should regularly review and reaffirm the hospital's mission statement with the board and staff.

By actively implementing these action items and fostering a culture of transparency, compliance, and mission-driven decision making, board members can fulfill their fiduciary duties and navigate the complexities of a distressed hospital effectively.

TGI thanks James D. Wall, Partner, and Cassidy L. Willard, Summer Associate, Waldrep Wall Babcock & Bailey PLLC, for contributing this article. They can be reached at jwall@waldrepwall.com.

