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Beware: Volunteer hospital directors are personally liable for breach of duty

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Volunteers who serve as directors of a nonprofit hospital may be lulled into a false sense of comfort, especially if they rely exclusively on information provided by hospital management and are only passively involved in the business of the hospital. Directors often assume they are insulated from potential liability by their volunteer status and the hospital's directors and officers insurance coverage.

In a decision last year, however, a federal bankruptcy court in Michigan allowed a case for damages to proceed against a hospital's interim CEO and five directors of the bankrupt Cheboygan Memorial Hospital (CMH). The court reviewed important questions involving breach of fiduciary duty and the application of the business judgment rule to both management and volunteer board members of the nonprofit hospital.[1]

Procedural history

In that case, the hospital had filed for Chapter 11 bankruptcy on March 1, 2012. The court confirmed a plan for liquidation in 2013, which provided that the CMH Liquidating Trust (the Trust) was vested with all causes of action that the hospital held against former directors and officers of the hospital. In 2014, the Trust filed a lawsuit alleging negligence and/or breach of fiduciary duty by the former officers and directors of the hospital. The Trust claimed that the defendants had:

- Failed to address losses from its employed physician practices;
- Failed to address billing and coding issues;
- Failed to ensure adequate control over financial issues, allowing the financial statements to overstate the hospital's revenues;
- Improperly approved the quick sale of a joint venture home health agency for less than fair market value in order to meet payroll;
- Allowed excessive senior management turnover to continue;
- Permitted excessive compensation to physician board members; and
- Allowed a conflict-of-interest transaction when the hospital refinanced $4.3 million in long-term debt with a bank whose president was a hospital director.

Bankruptcy court decision

In ruling on the defendants' motion to dismiss, the court dismissed certain claims while finding that the plaintiff had stated sufficient facts to proceed against the hospital's interim CEO and five directors.

Michigan law permits corporations by their articles of incorporation to provide broad protection from liability for a "volunteer director," which is defined as a director who receives nothing more than nominal value from the corporation for serving as a director other than reasonable per diem compensation and reimbursement for actual, reasonable, and necessary expenses.[2] The court found that one director had a conflict of interest between her roles as a director and as president of the bank that loaned the hospital money, and that another physician director was not a disinterested "volunteer," because he received excessive compensation for his board service.

In addition, the court permitted the case to proceed against three other directors whom the plaintiff alleged were not volunteer directors. These directors all allegedly served on the board at the time of the sale of the joint venture and allowed the payments to be made to the above-mentioned bank. The court dismissed all claims against the other volunteer directors, holding they were immune from liability under Michigan law based on certain exculpatory language in the hospital's articles.

The court also reviewed the business judgment rule, which creates a presumption that in making a business decision, directors of a corporation are protected if they act on an informed basis, in good faith, and with the belief that the action is in the best interests of the company. However, under Michigan law, this rule only protected disinterested directors. Moreover, if the plaintiff could show that the defendant directors were given actual notice of the need to take action, this rule would not protect directors who had abdicated their authority or simply failed to act.