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Corporate Law & Governance Update

A monthly briefing for the Nonprofit Health Care General Counsel

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The following developments from the past month offer guidance on corporate law and governance law as they may be applied to nonprofit health care organizations:

THE HERSHEY GOVERNANCE SETTLEMENT

On Friday, July 29, the Pennsylvania Attorney General, the Hershey Trust Company and the Milton Hershey School, entered into a **written settlement** resolving an investigation conducted by the Attorney General concerning certain governance practices of the two entities. The high profile of both the parties and of the investigation, and the terms of the settlement, are worthy of health system governance committee review.

The investigation had been prompted by Attorney General concerns with Hershey compliance with a previous 2013 settlement between the parties on certain governance related issues. The key terms of the 2016 settlement reflect the particular focus of the Attorney General's scrutiny. Those terms included ten year term limits for board members; mandatory performance evaluations; the resignations of five individual directors; required notice to the Attorney General on board nominations and a best efforts commitment to nominate candidates with appropriate education, training and experience; limits on director compensation; limits on cross-directorships with other Hershey-related entities; and clarifications to the existing Hershey conflicts of interest policy.

The settlement brings to a close what has been to date one of the most prominent governance controversies in the nonprofit sector. While the terms and conditions set forth in the settlement reflect the measures deemed necessary by the Attorney General to protect the charitable interests, they should not be viewed as *per se* governance "best practices." The more significant lesson to nonprofit health systems from the settlement is the extent to which state charity officials will scrutinize and investigate charitable organizations where deemed necessary to preserve charitable assets—and the financial, operational and reputational costs (to both the organization and to individual directors) arising from such scrutiny.

NEW GOVERNANCE PRINCIPLES

On July 21, a diverse consortium of prominent corporate executives and business leaders released the compilation, "**Commonsense Principles of Corporate Governance**." The compilation contains a series of recommendations within nine broad categories of governance, most of which are highly relevant to health care systems (whether for-profit or nonprofit).

The stated goal of the consortium members is to offer the recommendations as a set of "Principles" on which they found common ground, in the hope that they will promote further conversation on corporate governance. The group's

consensus reflects a shared belief that "empowered" boardmembers and shareholders contribute to long term corporate success through the provision of meaningful governance-based oversight. Indeed, the Principles draw an important connection between effective corporate governance and economic growth. As such, the Principles serve as an excellent topic for discussion by health system board governance committees, with the assistance of the system's general counsel.

Those Principles most relevant to health system governance are those that address Board Composition, Director Responsibilities, Director Education, Committee Matters, Director Independence, Board Agenda, Director Refreshment, Succession Planning and Corporate Reputation.

Several of the Principles' more progressive recommendations may prove controversial with some CEOs, especially those who wish to keep tight control of who has access to their boards, and to whom their boards have access. These potentially controversial Principles include those that promote (a) the use of outside advisors and experts in making board education presentations; (b) implementation of a pure, undiluted executive session practice; (c) "unfettered" board access to the entire management team; and (d) talent development practices that allow for direct board exposure to key company employees.

When advising leadership, the general counsel should be careful to describe the Principles both for what they are -- recommended, "commonsense" guidelines, and for what they are not -- absolute standards or "best practices." The real value in the Principles is the opportunity their release offers for new, meaningful dialogue on governance matters within the board.

THE GC/CFO RELATIONSHIP

An important **new article in the *Harvard Business Review*** speaks to the critical importance that should be attributed to the General Counsel/Chief Financial Officer relationship. The article's emphasis on a necessary "alliance" between these two key officers should be closely considered by the executive committee (if not the entire board) and by the CEO.

The article, written by the estimable Ben W. Heineman, Jr., is premised on two key developments: first, the increasingly consequential integration of the finance and legal functions of a corporation; and second, the dramatic evolution of the expertise, quality breadth, power and compensation of the GC. According to Mr. Heineman, "the optimal CFO-GC alliance is now more like a peer relationship, jointly coordinating and overseeing fundamental corporate issues of performance, compliance, ethics, risk and governance, and organization." In addition, Mr. Heineman attributes to both officers the attribute as corporate "statespersons", as it relates to the preservation of organizational ethics and reputation. Acting simultaneously as partners to senior corporate leadership and as guardians of the corporation, the expectation is that they will work collaboratively to preserve a "pervasive culture of integrity." This recommended partnership is expected to contribute significantly to effective corporate action.

Particularly interesting may be Mr. Heineman's recommendation that the GC and CFO share responsibility for designing compliance systems and processes that ensure adherence to formal legal and financial rules. Working in conjunction with compliance and risk departments, he projects the GC and CFO as working together effectively to develop robust internal procedures of process mapping, risk assessment and risk mitigation relating to rules that apply to all corporate functions.

This unique and important perspective is consistent with the emerging "best practice" that positions the general counsel as not only a legal technician, but also as a valued business partner of management and counselor on organizational ethics. It is similarly consistent with corporate responsibility principles that advocate for a GC-to-CEO (or COO) reporting relationship as opposed to a GC-to-CFO reporting relationship. Importantly, it also acknowledges the obstacles that sometimes arise between the finance and legal functions. Its call for a "strong, respectful, mutually supportive partnership" between the GC and the CFO should be closely considered by corporate governance and the CEO.

GOVERNANCE OVERSIGHT OF CYBERSECURITY

Most health system governing boards have some basic awareness of the cybersecurity issues that confront their organizations. Two recent developments serve to confirm the significance of those risks, and help to underscore the board's critical oversight obligations in the area.

The first development is the **July 18 agreement** by which Oregon Health & Science University settled potential HIPAA violations through a monetary payment of $2,700,000 by OHSU to the Department of Health and Human Services. The settlement was prompted by an HHS Office of Civil Rights investigation that found widespread and diverse problems at OHSU. OCR's investigation began after OHSU submitted multiple breach reports affecting thousands of individuals, including two reports involving unencrypted laptops and another large breach involving a stolen unencrypted thumb drive. The investigation ultimately uncovered evidence of widespread vulnerabilities within OHSU's HIPAA compliance program. The cited problems will be addressed through a comprehensive three-year corrective action plan. Notably, in its press release announcing the settlement, OCR was highly critical of OHSU's security management processes. "This settlement underscores the importance of leadership engagement and why it is so critical for the C-suite to take HIPAA compliance seriously."

Of similar board oversight relevance is the August 4, 2016, settlement between Advocate Health Care Network and the OCR for multiple potential HIPAA penalties involving ePHI. Advocate will pay a settlement amount of $5.55 million and adopt a corrective action plan. According to **OCR's press release**, the penalty is the largest to-date against a single entity, and reflects the extent and duration of the alleged noncompliance. As with the OHSU settlement, the OCR press release contains something of a warning from OCR Director Jocelyn Samuels: "We hope this settlement sends a strong message to covered entities that they must engage in a comprehensive risk analysis and risk management to ensure that individuals' ePHI is secure."

RESPONSIBLE CORPORATE OFFICER DOCTRINE

The continued willingness of federal courts to apply the harsh Responsible Corporate Officer Doctrine (RCOD) presents particular compliance—and executive retention—challenges for boards of certain types of life sciences and health care companies. A recent decision of the Eighth Circuit, upholding prison sentences for executives held to have committed misdemeanor violations of federal food and drug laws, confirms the continued viability of this enforcement theory as part of the government's enhanced efforts to hold individuals responsible for corporate wrongdoing.

The Eighth Circuit's July 6, 2016 opinion in ***U.S. v. DeCoster*** upheld three month prison sentences for two commercial farm executives who had pled guilty to misdemeanor violations of the Food Drug & Cosmetic Act (FDCA) for introducing into interstate commerce salmonella-tainted eggs. The executives had appealed their sentences, arguing that the RCOD is unconstitutional and that the sentences were unreasonable on procedural and substantive bases.

The Court of Appeals concluded that the defendants were not required to have known that they violated the FDCA in order to be subject to the criminal penalties, *nor were they required to have actual knowledge of the wrongful conduct* [emphasis added]. The inference (supported more clearly by the Concurring Opinion) was that the defendants' responsibility was grounded in negligence--their failure to exercise sufficient care to prevent the introduction of the spoiled eggs into commerce.

Harsh enforcement theories such as RCOD [and certain elements of and OIG's permissive exclusion authority] reflect extreme extensions of the current federal focus on individual accountability for corporate wrongdoing. As such, they present unique governance and executive retention challenges to the boards of life sciences and health care companies. These challenges may be met, in part, in two ways: first, by enhancing the efforts of senior executives to support compliance measures (helping to rebut suggestions that executives were negligent in their supervision of the organization and its commitment to legal and regulatory compliance); and second, by increasing personal liability protections available to those executives.

CEO SERVICE ON OUTSIDE BOARDS

Newly revised policies adopted by the University of California Board of Regents provide an opportunity for health system boards to revisit the protocols they apply to review the appropriateness of outside business interests—including but not limited to outside board service—of senior executives. These types of protocols are typically premised on the core assumption that many such outside interests bring value to the organization and are to be encouraged.

The emphasis of the new UC policy revisions are three-fold: ***First***, to reinforce the existing requirement that senior executive members must obtain approval for all outside activities, whether compensated or uncompensated, before they may engage in the activity or announce participation in the activity; ***Second***, to strengthen the authorization process by adding an additional level of approval to the process by which an executive's request to participate in the outside activity may be authorized (*i.e.*, so that the executive's request would be reviewed and signed off on by both his/her manager and by the next higher level manager as well); and ***Third***, in addition to completing currently required disclosure forms, senior executives would be required to submit a statement describing the benefits that accrue to the University for any proposed outside activity.

As the UC policy notes, such outside service often inures to the overall benefit of the organization. Indeed, by the nature of their experience and perspectives, health system senior executives are frequently in demand, for various appropriate reasons, by outside business and charitable organizations as board members, consultants or advisors. However, such outside service can, in certain circumstances, present issues relating to conflicts of interest, conflicts of commitment and tax/compensation and benefits issues. For that reason, sophisticated internal policies, such as the revised UC policy, can be helpful in balancing the value of such outside service, with the legal and reputational issues that may potentially arise therefrom. As such it may be an appropriate agenda item for a future governance or executive compensation committee meeting.

INTERLOCKING DIRECTORSHIPS/ANTITRUST RISKS

On July 14, **The Department of Justice announced** that two providers of electronic brokerage services restructured their $1.5 billion transaction after the Department expressed Clayton Act Section 8 concerns. This underscores the antitrust risks arising from interlocking boards between corporations that could reasonably be considered as competitors. Section 8 compliance is an increasing legal feasibility issue with certain types of governance arrangements arising in the rapidly consolidated health care industry.

In general, Section 8 of the Clayton Act prohibits a person from serving as a director or board-elected or board-appointed officer of two competing corporations whose profits and amount of competing revenues exceed inflation-adjusted statutory thresholds. The primary purpose of Section 8 is to prevent harm to competition by removing the opportunity or temptation to violate the antitrust laws through the interlock. Private parties may bring an action to enforce Section 8. The principle remedy for a violation of Section 8 is removal of the interlocking directors or officers (injunctive relief). As originally structured, the transaction that was the subject of the Department's July 14 announcement would have created an interlocking governance arrangement between two competitors, where one organization had the authority to nominate one member of the other organization's governing board. The transaction was ultimately restricted to eliminate the director nomination right (and a related 20 percent ownership interest by one organization in the other).

This announcement demonstrates DOJ's interest in enforcing Section 8 where necessary to prevent "a cozy relationship amongst competitors." Of course, the application of Section 8 depends upon the facts and circumstances of particular arrangements and the extent to which they meet certain statutory thresholds. This is particularly the case as concepts of what constitutes "competition" may evolve, given the increasing scope of operations of many health systems, and the growing diversity of their business operations. The general counsel may wish to use this new DOJ action to remind her colleagues who structure business transactions and governance relationships between corporations (that could plausibly be considered to compete with each other) to pro-actively consider the potential Section 8 implications of those proposed transactions and relationships.

DEREK JETER AND FIDUCIARY BREACH

A **recent decision of the Delaware Chancery Court** involving Derek Jeter provides a topical opportunity to remind governing board members that fiduciary duty challenges can ensnare even the most legendary and respected public figures. By the decision, the Court required Mr. Jeter to defend himself against allegations that he breached certain fiduciary duties to an underwear manufacturer for which he served as a board member.

The case arose from an unusual arrangement whereby Mr. Jeter agreed to join the manufacturer's board as part of a "reverse endorsement" strategy, whereby Mr. Jeter's board membership and minority ownership interest would hopefully serve as an endorsement of the manufacturer's product. Mr. Jeter entered into a director's agreement that served to create a fiduciary relationship with the manufacturer and required Mr. Jeter to perform certain requirements (including making a public announcement about his role with the company). Mr. Jeter had initiated the litigation, seeking a declaration that he had satisfied his obligations under the agreement. The manufacturer counterclaimed, alleging, among other claims, that Mr. Jeter violated his fiduciary duty by making false statements to investors in bad faith while serving on the manufacturer's board.

As Vice Chancellor Glasscock noted in the introduction to his opinion, "This case provides a cautionary tale of the mixing of roles in a corporate governance setting." In Mr. Jeter's circumstance, the mixing of roles involved the confusion between the goals and expectations under the reverse marketing arrangement, and the fiduciary obligations he assumed as a director and under the director's agreement. Evolving governance arrangements in the health care industry offer the potential for a similar mixing of governance roles. This could arise, for example, with non-traditional arrangements involving so-called "celebrity directors"; exceptionally important donors; "fly-in directors"; certain types of constituent directorships and similar situations, where there is lack of clarity on the nature of the director's board service and fiduciary relationship to the health system. The case also offers a useful example on the types of actions and nonactions that could give rise to a breach of loyalty claim.

COMPLIANCE EDUCATION GAPS

A **new survey** of almost 650 ethics and compliance professionals found significant gaps in training topics offered to boards, when compared to training programs on similar topics provided to employees. The results suggest the need for substantially increased board education on a diverse assortment of risks, including those associated with cybersecurity, workplace harassment and conflicts of interest.

The survey, conducted by the prominent compliance software services company Navex Global, found that for cybersecurity, 13 percent of surveyed organizations offer training for their boardmembers, while 69 percent of their employees receive such training. For conflicts of interest, 19 percent of surveyed companies provide board member training while 76 percent of their employees receive such training. For workplace harassment, the "split" is even more pronounced, with only 7 percent of surveyed companies providing board member training while 76 percent of their employees receive such training. In addition, of the 58 percent of surveyed companies that report training board members on risk matters, only 20 percent offer such training in new director orientation processes. On a more positive measure, 70 percent of the surveyed organizations identified 'creation of a culture of ethics and respect' as the most important goal of ethics and compliance training.

These survey results are potentially significant in at least four respects. First, the new "Commonsense Governance Principles" (see above) strongly recommend robust board education programs. Second, allegations of workplace harassment within prominent corporations have been quite in the news of late. Third, conflicts of interest issues go to the director's core duty of loyalty, and there may well be need for education on the application of that duty and of the organization's conflicts policies. Fourth, the effectiveness of board education programs generally, and ethics and compliance training in particular, should be a shared focus of the governance/board development and audit/compliance committees. Finally, the board's willingness to receive additional education on these and similar issues may be perceived as evidence of their good faith, and of the proper "tone at the top." The general counsel may wish to "team" with the chief compliance officer in sharing these survey reports with the proper board committees.

GENERAL COUNSEL CONFLICTS OF INTEREST

According to ***The Wall Street Journal***, the chief legal officer of a major banking institution was recently 'separated' from the institution for what was described by the institution as a conflict of interest arising from a personal matter. This development focuses attention on the extent to which corporate conflicts policies should, and do, apply to in-house legal counsel.

The banking institution made no additional elaboration on the reasons for the separation nor on the nature of the conflict. It did acknowledge that the separation had nothing to do with the former CLO's legal work, and described the former CLO as "a very qualified lawyer."

Most large health systems have detailed board level conflicts of interest policies and procedures, including extensive conflicts disclosure policies and related procedures designed to support board members in the identification and disclosure of potential conflicts. Most such policies have specific procedures by which disclosed board member conflicts are evaluated to determine whether an actual conflict exists and, if so, what remedy should be applied. Fewer health systems have elaborate policies addressing conflicts of interest issues of executive officers, even though in many states those officers may be bound by the same duty of loyalty as are board members. However, some systems are moving toward more detailed review of the outside business interests of their executives [see above].

It would be inappropriate to speculate on the nature of the former CLO's alleged conflict and on why the institution felt that separation was necessary. However, this situation may help health system general counsel and their executive colleagues to be more pro-active in evaluating the sufficiency of existing COI procedures and conduct codes affecting senior executive officers. It may also increase consideration of periodic consultation by CLO/GC with outside professional ethics counsel on matters that relate to professional duties and responsibilities, and compliance with internal corporate policies.

FOR MORE INFORMATION

For additional information on any of the developments referenced above, please contact Michael at +1 312 984 6933 or at mperegrine@mwe.com; or visit his publications library at **https://www.mwe.com/peregrinepubs**.

Highlights of July's Published Articles and Speeches/Decks

- Commonsense Governance Principles: Returning Governance to its "Commonsense" Roots
- A United Effort to Overhaul Corporate Governance
- New Governance Best Practices Released
- Mid-Year Top Ten Governance Trends for Health Care Systems Podcast
- Compliance Oversight: Legal Issues Checklist
- Corporate Governance and Corporate Compliance: A Roadmap for the "Yates" Environment