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Corporate Law & Governance Update

A monthly briefing for the Nonprofit Health Care General Counsel

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:

HEALTH POLICY INITIATIVES

Perhaps the most critical challenge facing the board as 2017 begins is the need for its members to gain both an awareness and an understanding of the health care policy initiatives currently under consideration in Washington. **What are they and what are their implications**—not only for the health care industry, but also for the health care system?

In order to be a meaningful sounding board to management; in order to render informed decision making and oversight, the health care director must be familiar with the answers to those questions. So much is in flux, but It appears that the most significant policy initiatives to arise in the short term will be those relating to Affordable Care Act repeal; Medicaid expansion and reform; Medicare reform; the continued implementation of various performance metrics and incentivizing risk-sharing models, including those contemplated by MACRA; and program payment cuts under traditional Medicare that could negatively impact institutional revenues. These policy issues have the potential to broadly affect the board agenda from the strategic to the transactional; from growth to contraction; from opportunities to risk; from financial posture to quality of care; and to all matters compensation.

The health system board, as well as certain of its key committees, will benefit from continuous briefings on these initiatives and their implications to both the health care industry and to the health system board's agenda in particular. The expected level of fiduciary diligence will be high.

CONFLICTS OF INTEREST MANAGEMENT

Continued media scrutiny of President-elect Trump's plans to divest or otherwise address his vast business holdings upon assuming office is indirectly driving much closer scrutiny of **how governing boards identify conflicts of interest**, and manage conflict arrangements they approve as being in the best interests of the organization.

As most general counsel are aware, many states provide a specific statutory "rebuttable presumption" for conflict-of-interest arrangements approved in advance by the board (or a committee with board delegated powers) under specific types of circumstances that speak to fair value, diligent review and the organization's best interests. When satisfied, these circumstances serve to shift the burden of challenging the particular action to the individual or entity that seeks to mount a challenge. However, the extent to which boards subsequently monitor approved conflict of interest arrangements can often provide supportive

evidence of the board's good faith in approving the arrangement, conflict notwithstanding. Many leading health system boards have formal templates they use to manage the continuing reasonableness of approved conflict of interest arrangements.

The coverage of the President-elect's divestiture proposals serves as a useful prompt to boards and their conflicts committees to revisit the various safeguards they apply to assure that approved conflicts arrangements serve the organization's best interests, consistent with the rebuttable presumption statute. This is particularly because, given the election and transition related backdrop, state charity officials may be more willing than in the past to evaluate the sufficiency of these conflicts management plans.

COMPLIANCE OVERSIGHT

The board's compliance committee will encounter a particularly challenging agenda in 2017. Its activity will be impacted by a series of recent corporate controversies, regulatory developments and judicial decisions. These combine to prompt a close committee review of its level of diligence, key elements of the compliance program and, most significantly, employee acceptance of the compliance culture.

The most impactful issues facing the committee include (i) the need for greater awareness of what courts, regulators or third parties might interpret as "inadequate or flawed" compliance oversight; (ii) policy initiatives encouraging more sophisticated compliance programs (*i.e.*, those that transcend minimum effectiveness standards such as those contained in the Federal Sentencing Guidelines); (iii) extending program coverage to areas that may not currently be fully addressed (*e.g.*, more vigorous enforcement of certain antitrust laws that affect employees who may not regularly interact with the compliance department); (iv) coordinating the duties of the growing number of corporate officers involved with matters of legal risk and compliance; and (v) evaluating whether the compliance "message" is accepted broadly throughout the organization (*e.g.* the potential for conflict between compliance initiatives and economic/compensation realities that many employees may perceive).

The collective significance of these could transform how the committee engages with respect to the traditional measures of program effectiveness, and provides direction to compliance program management.

WASTE OF ASSETS

"Waste of assets" is a liability theory that has been used in the past to challenge corporate transactions that are perceived to be an exceptionally unjustified use of resources. While **a new scholarly article** concludes that the application of this theory is in decline in the business corporation context, it remains an available, if unique, enforcement tool for state charity officials, particularly in states that have charitable trust-based statutes.

Business transactions and executive compensation arrangements are the types of arrangements that have most often attracted "waste" allegations. Courts have historically acknowledged "waste of assets" arguments in circumstances where "there was an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade." In other words, for "waste" arguments to overcome a business judgment rule defense, the plaintiffs must allege that the business arrangement was so one-sided that "no business person of sound judgment could conclude that the corporation has received adequate consideration." A tall burden of proof, indeed.

However, the health system general counsel will note that "waste of assets" arguments may be easier to assert in the nonprofit context given the dedication of corporate assets for nonprofit purposes. Indeed, **many state charitable trust codes** specifically address the fiduciary obligation to avoid waste of charitable assets. It is also important to note that "waste" allegations are usually framed as a challenge the board's exercise of business judgment (*i.e.*, that there are limits to the application of the business judgment rule). While the charity regulator may have other enforcement tools available to challenge portions of suspect business arrangements, the "waste of assets" claim may be an attractive approach in situations where there is the perception of significant abuse or grave concerns about the reasonableness of the arrangement—or where the regulator may seek to place particular enforcement pressure on the nonprofit and its board.

FRAUD EXCEPTION TO D&O COVERAGE

A recent judicial decision underscores the value in confirming the extent to which directors' and officers' insurance provides coverage for fraud and similar conduct, and the need to communicate the scope of coverage (or the lack thereof) to the board. This is particularly important given the current enforcement environment that continues to focus on individual accountability for corporate wrongdoing.

The decision related to a prominent controversy in which the insured—a former CEO and minority owner of a company—had been held (in a prior shareholder derivative decision) to have breached his fiduciary duty to the company in connection with his proposed privatization of the company. The damage opinion awarded almost $150 million. The former CEO settled the case and paid the damages, and the case was dismissed prior to the entry of a final judgment. The former CEO then sought to be reimbursed by the company's D&O carrier, which (naturally) declined on the basis that the policy included an exclusion from coverage for litigation with respect to the personal gains of a director obtained by fraud. The Delaware Supreme Court ruled in favor of the defendant on the grounds that there was no final judgment, even though there was a Court of Chancery opinion finding the ex-CEO liable.

This case involves a complex set of facts, and the controversy may not yet be fully resolved. Yet it provides an opportunity for the general counsel to discuss with the board, or a related committee, the treatment of fraud allegations and judgments under the company's D&O policy. This would be a relevant discussion given general "gatekeeper anxiety" concerns, especially as several recent FCA settlements in health care include damages payable by corporate officers and directors; the exposure to allegations of fraud is certainly on the minds of many fiduciaries.

RECONCILING DIVERSITY AND COMPETENCY

Board governance and nominating committees are increasingly being called upon to address the often conflicting, yet equally important, interests of diversity and of competency in their selection of board and committee member candidates. The public policy and governance implications of these two "best practices" can often be difficult to reconcile.

On the one hand, new principles of corporate governance call on boards to develop specific protocols aimed at identifying "appropriately diverse candidates," to facilitate the ability of the nominating committee to consider women, minorities and others with diverse backgrounds as candidates for open board seats. On the other hand, most governance principles still recommend the nomination of candidates with specific skillsets that are heavy on industry background and experience, or possess backgrounds in other types of leadership positions that are directly related to the company's business. The governance expectation has been that more precise competencies would enhance the exercise of informed oversight and decision-making, in support of the long term success of the organization.

A possible solution is for the committee to pursue **"diversity along multiple dimensions"** –including diversity of thought and experience as well as race and gender. The nominating committee need not retreat from principles of competency based governance as much as if choose to recast concepts of competency in a more inclusive manner; one that attributes new value to skills, experience and expertise that is reflective of the broader range of society. It is an issue that is worthy of fulsome committee discussion.

THE FUTURE OF YATES

The audit and compliance committee may wish to adopt a pragmatic perspective to continued law enforcement focus on individual accountability for corporate wrongdoing following the change of administrations. **This, as conjecture abounds as to the likely orientation of the Department of Justice following the inauguration.**

Indeed, the "die" is pretty much "cast"; addressing issues of individual accountability looks to remain a governing board consideration for the foreseeable future, regardless of changes in enforcement practices implemented by the Trump administration. On matters of civil and criminal enforcement; allegations of breach of fiduciary duty; securities regulation and investigative media orientation, the focus will likely continue to be on "following the conduct"--identifying individuals who can be held responsible for organizational misconduct, wherever they may reside in the corporate hierarchy. As an example, **a senior DOJ official recently noted** that a significant number of corporate investigations commenced after the issuance of the Yates Memo will not

result in public filings until well into the next administration. And in those cases, government agents and prosecutors are focusing on whether any individuals should be subject to criminal or civil penalties. Thus, her prediction is that, in the near term, a higher percentage of corporate settlements with DOJ will include criminal or civil actions against the responsible individuals.

The board is well advised to confront this reality not only by enhanced legal compliance efforts, but also by assuring gatekeepers and others of the liability protections made available to them by the organization. These strategies will be premised on an enhanced awareness of board members of their expected fiduciary obligations for compliance program oversight.

RECENT BOARD SURVEYS

Two new board surveys may provide valuable data points for the governance committee of health system boards. Even though the surveys focus primarily on public companies, many of the surveyed governance issues are highly relevant to large, financially and operationally sophisticated nonprofit health systems.

The new **Stanford/Rock Center for Corporate Governance** survey examines issues of boards of directors' evaluation and effectiveness. Its key takeaway is that while surveyed directors are comfortable that the board's expertise is sufficient to oversee the company and its management, there are significant negative perceptions with respect to the manner in which directors are evaluated, the process for removing nonperforming directors, and the effectiveness of board dynamics and board engagement as a whole. Takeaways from **the 2016-2017 NACD Public Company** Governance Survey include (i) significant apprehension with respect to economic uncertainty and business-model disruption; (ii) an interest in increased board participation in strategy; (iii) concern that insufficient board/committee time is allocated to many key issues; (iv) the need to improve the evaluation process; and (v) a lack of confidence in the effectiveness of board oversight of cybersecurity.

The Stanford and NACD surveys are excellent resources for health system governance committee discussion. The survey results are highly relevant to health system boards, especially to the extent that they address issues relating to critical board priorities, board involvement in strategy discussion, the state of board risk oversight, and benchmarks on governance practices.

BOARD COMPOSITION PRACTICES

The 2016 edition of the annual **Spencer Stuart Board Index** offers health system board nominating committees with a valuable insight on how their peers on the boards of S&P 500 companies are addressing matters of board composition. In the absence of particularly reliable data on board composition practices of large nonprofit health systems, the Spencer Stuart report might provide a useful point of reference to the nominating committee.

Particularly interesting data relate to such key factors as (i) the qualifications and background of new independent directors joining boards; (ii) a decrease in actively serving senior executive officers (*e.g.*, CEOs and COOs) joining the boards of other companies; (iii) wide disparity in practice as to director tenure, term limits and retirement age; (iv) overboarding concerns and policies; (v) the extent to which companies implement evaluations of the full board, committees and individual directors; (vi) trends in board size and meeting frequency; (vii) board member compensation; and (viii) board representation of women and minorities.

To be sure, some public company board practices reflect pressure from activist investors, and the short term/long term interests conflict. That notwithstanding, experience suggests that the vast majority of governance practices reflected in the Spencer Stuart and similar public company surveys are worthy of reference by nonprofit health system boards because of their similarity in operational and financial sophistication.

SUPPORTING UNUSUAL COMPENSATION DECISIONS

An article in the December 27 *Boston Globe* demonstrates the organizational value of additional diligence by the board and its executive compensation committee in establishing a strong record of support and reasonableness for executive compensation decisions that may be regarded by others as unusual or an outlier.

The article focused on a $1.34 million payment made by a large nonprofit organization (noted in the article as one of the largest in Massachusetts) to its long-time president. The

article notes that the amount was paid in 2014, but was disclosed on a recently filed Form 990 return. The board chair commented on the president's value and cited the fact that the president had consistently been underpaid relative to leaders of similar nonprofits over the preceding decade. The article, and the subsequent mention in the *Chronicle of Philanthropy*, is notable in demonstrating the value of board leadership providing a succinct and supportive explanation of an unusual compensation decision. Because unusual or large compensation amounts can generate media scrutiny potentially years later (as demonstrated by this article's focus on a 2014 payment), other organizations also should be ready to provide appropriate and supportive comments on their compensation decisions – even several years after the fact.

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 Recent Publications

- The "Appearance" of Conflict: New Challenges for Board Review
- The Board's Compliance Committee: A Transformative 2017 Agenda
- Managing the Parent/Subsidiary Relationship: A Checklist for the General Counsel
- Beyond *Caremark*: Individual and Corporate Liability Considerations