

COMPILED WITH COMMENTARY
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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:

BUSINESS ROUNDTABLE GOVERNANCE GUIDELINES

In an important governance development on August 3, the influential Business Roundtable (BRT) released a 2016 edition of its well-known “**Governance Principles**” monograph. This new release is a comprehensive revision of the 2012 edition of the Principles, and should attract close attention from corporate directors and their advisors.

The 2016 edition of the BRT Principles offers a comprehensive treatment of key principles of governance, and also fundamental governance issues such as board responsibilities, roles of key corporate actors, committee responsibilities and other, elemental governance concerns historically treated by the organization. These include board composition, director responsibilities, shareholder rights, public reporting, board leadership, management succession planning and compensation of management.

What may be particularly persuasive to health system leaders is that the Business Roundtable is an association of business executives, and that the Governance Principles reflect those issues and trends its CEO members perceive as influencing governance today.

The board should consider the new BRT Principles together with the similarly new “Commonsense Principles of Corporate Governance” released on July 25 by the Buffett/Dimon consortium of executives.

On its own, the release of either of these two commentaries would have been a significant event, and worthy of governance committee attention. For two sets of substantial commentaries to be released in close proximity to one another is particularly consequential—and a primary reason for the general counsel to bring them to the governance committee’s attention.

SPECIAL FOCUS ON DIVERSITY

One of the most prominent and publicized themes of the Business Roundtable’s new governance guidelines (see above) is its significant emphasis on diversity in the board nominating process. This will add to the pressure on health system boards to increase their commitment to diversity in governance.

BRT’s perspective that more diverse boards—including directors who represent the broad range of society—will strengthen board performance and contribute to the fundamental goal of creating long term value. To that end, BRT recommends that boards “develop a framework for identifying appropriately

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diverse candidates that allows the nominating/governance committee to consider women, minorities and others with diverse backgrounds as candidates for each open board seat.”

In this regard, the BRT Principles take the diversity commitment to a degree beyond those of many other governance compilations, and track recent related comments of SEC Chairperson Mary Jo White. The BRT Principles do not “take sides” in the external debate on whether increased racial and gender diversity correlates to improved corporate financial performance. Rather, they support the broader concept that corporate decision-making, and talent acquisition, benefits from an environment that is supportive of diversity in backgrounds and perspectives.

NEW JUDICIAL EVALUATION OF “CAREMARK” STANDARD

A new Delaware Chancery Court decision provides additional clarity on the burdens associated with substantiating a claim of breach of fiduciary duty for compliance program oversight (the so-called “Caremark” duty). The case also allows general counsel to address with key board committees how this duty may be (differently) evaluated in the context of a governmental enforcement action.

The case—a shareholder derivative action—was based upon allegations that the company’s board was aware of several company violations of antitrust laws yet failed to take pro-active steps to improve antitrust compliance. The court reiterated that evidence of “bad faith” (*i.e.*, “conscious disregard”) was necessary to establish the elements of a Caremark claim. According to the chancery court’s definition, incorrect exercise of business judgment in response to compliance “red flags” is insufficient to constitute bad faith.

It has been often noted by courts that Caremark claims are among the most difficult corporate litigation claims to be instituted against board members. However, it should be noted that there are no leading state or federal decisions that conclusively apply the Caremark “bad faith” standard to nonprofit boards. Further, it is uncertain that the Department of Justice, the Office of Inspector General and other regulatory agencies would feel limited by the Caremark standard in evaluating the effectiveness of corporation’s compliance plan (and the board’s oversight role thereof) in the context of a governmental investigation. The health system general counsel is well suited to place Caremark-related judicial decisions in the proper context for the governing board.

INTERMEDIATE SANCTIONS ANNIVERSARY

July 30 marked the 20th anniversary of the enactment of the [Intermediate Sanctions provisions of the Internal Revenue Code](#) (Section 4958). This anniversary provides the nonprofit health system general counsel with a unique opportunity to remind senior leadership of the provision’s continuing relevance—and enforcement risks as well as review the current procedures in place to protect against Intermediate Sanctions to make certain such procedures are best practice.

The purpose of the new provision was to provide the Internal Revenue Service (IRS) with an alternative enforcement option (*i.e.*, other than revocation) to incidents of private inurement or other forms of “excess benefit” arrangements that do not call into question the continued tax-exempt status of the nonprofit entity. As most general counsel are aware, Section 4958 authorizes the Service to impose penalty excise taxes on “excess benefit transactions” between “disqualified persons” and their respective Section 501(c)(3) or 501(c)(4) organization. While the organization itself is not subject to penalty, organizational managers (including, board members, officers and persons having similar powers or responsibilities to board members and officers) may be subject to personal excise tax penalties.

Section 4958 is a highly complex statute not only with respect to determining what constitutes an excess benefit transaction and the circumstances under which excise tax penalty exposure is created, but also the circumstances under which the “Rebuttable Presumption of Reasonableness,” which presumption provides meaningful protection against the imposition of Intermediate Sanctions (and, more generally, helps demonstrate that the board member or officer is adhering to their fiduciary duties), are satisfied. Unlike other some other state and regulatory agencies, the IRS does not generally publicize incidents of Section 4958 enforcement. Nonetheless, violations of the Intermediate Sanctions rules must be self-reported by the organization on its annual Form 990, which filing is a publicly available document. For these and other reasons, the “Anniversary” may provide a welcome opening for the general counsel to review with key board committees the law’s application to non-profit health system leaders.

“D&O”/ADVANCEMENT/INDEMNITY ISSUES

Given the current regulatory enforcement environment, an increasingly important responsibility of the general counsel is to advise the corporation, and its officers and directors, on the

application and extent of insurance/advancement and indemnification protections. Several new cases demonstrate how important this responsibility can be.

For example, an [August 4 decision](#) of a federal district court in Colorado concluded that a company's then-existing D&O policy did not provide coverage for the costs incurred by the company

in responding to an SEC investigation. Based upon the nature of the SEC inquiry, the court determined that it did not reflect the allegation of a "Wrongful Act" by the company as required in order to constitute a "Claim" under the policy. Rather, the court interpreted that it was an investigation to determine whether the company had indeed violated the law.

In an [unrelated Delaware decision](#), litigation expense advancement was denied to a corporate vice president. The court ruled, based on applicable state law, that an employee becomes a corporate officer (and entitled to advancement benefits) only as provided by the corporation's bylaws. In this instance, the bylaws provided that officers must be elected by the board (and vice presidents were not so elected).

These and similar decisions may prompt the health system general counsel to review with organizational leadership the extent of current insurance and indemnification rights, and identify areas for possible enhancement. Such efforts may be particularly useful given the "gatekeeper anxiety" arising from the Yates Memorandum.

THE COO AND THE GC'S REPORTING RELATIONSHIPS

An [August 24 article in *The Wall Street Journal*](#) addresses what is described as a trend with leading corporations to eliminate the chief operating officer position, in order to "flatten" management structures. To the extent the chief financial officer assumes the COO duties—as is suggested by *The Journal*—it could complicate the general counsel's reporting relationships.

In many large organizations, including organizationally complex health systems, the general counsel directly reports to the COO. This reporting relationship is consistent with corporate responsibility principles, when the COO carries out the day-to-day duties of the CEO and the general counsel has futility bypass rights to the CEO and to the board, respectively. [However, such principles generally discourage a "general counsel-to-CFO reporting relationship,"](#) for many reasons (e.g., their respective roles in

financial reporting and disclosure; the CFO's role in transaction development and budget development, etc.).

Thus, the CFO becoming the general counsel's "direct report" may create a corporate responsibility dilemma. Indeed, enforcement agencies are increasingly evaluating reporting relationships for indicia of organizational commitment to legal compliance. Thus, the potential conflicts and tensions arising from such a shift should be closely considered by senior management, and protections built into the new relationship.

SEVERANCE AGREEMENT CHALLENGES

The health system general counsel may wish to take note of recent SEC enforcement actions with respect to severance agreements that were interpreted by the Commission as limiting the ability of outgoing employees to file applications for SEC whistleblower awards. The general counsel may wish to coordinate her response with the SVP/Human Resources, and with the Chief Compliance Officer.

In orders announced [August 10](#) and [August 16](#), respectively, the SEC announced that two separate companies had agreed to pay monetary penalties and to implement other remedial action for (allegedly) illegally using severance agreements as a means of placing barriers to accessing the SEC's whistleblower program. In one order, the cited conduct was a waiver and release of claims that was interpreted by the SEC as prohibiting the outgoing employee from filing an application for, or accepting, a whistleblower award from the SEC. In the second order, the cited conduct was a confidentiality provision in the severance agreement that (allegedly) prohibited the ability of the outgoing employee from sharing with anyone (presumably including the SEC) confidential information the outgoing employee had learned about the company during the period of employment

This enforcement action is relevant to both publicly traded and nonprofit health systems. Whistleblower activity is generally considered to be an important element of an organization's overall compliance program. The general counsel may wish to coordinate with HR and compliance colleagues to make sure that severance agreements achieve their intended goals without placing problematic barriers on certain types of protected whistleblower activity.

CONFLICTS OF INTEREST DEVELOPMENTS

A series of recent developments combine to reflect closer scrutiny of relationships and other arrangements that raise conflict of interest issues at the director and officer level. In so doing they serve as a

“prompt” to review the effectiveness of existing health system conflicts disclosure and review processes.

The most significant of these developments was the August 21 feature story in *The Wall Street Journal*, “Nonprofit Hospitals’ Business Relationships Can Present Conflicts.” The article focused on business relations between the hospital, its executives and its board members, drawing from information available in the Form 990. The article focused on the frequency by which hospitals and health systems conduct business with their board members and the substantial dollar amounts allegedly involved in those arrangements.

To this point, the article profiled three separate business transactions involving a health system and corporate “insiders” (or their family members). While the article contained the normal caveat about the mere existence of a conflict not necessarily suggestive of legal concerns, the inference in each case was that a presumption of bias existed.

This article and other new developments serve as a strong reminder for health systems to review the sufficiency of their policies with respect to the disclosure and determination of conflicts; the outside business activities of executives and board members; and the reputational and other issues associated with arrangements that create the “perception” of a conflict of interest.

DEFINING “CHIEF LEGAL OFFICER”

A new article in *Corporate Counsel* speaks to the growing use of the term “Chief Legal Officer” by large organizations to denote the senior legal officer, and to reflect the role of that officer as a “business partner” with the members of the executive leadership team. The article reflected the perspectives of several legal search professionals.

The concept of the “CLO” is relatively new and, as a result, it does not appear to carry **with it any broadly accepted definition**. Experience suggests that the title is used to bestow greater authority and greater organizational prominence.

To date, the title “CLO” seems most often used with companies that are multi-jurisdictional and/or multi-departmental in scope, with many subsidiaries and perhaps several regional or business division general counsel. It is a position that essentially is intended in some circumstances to incorporate those additional duties of business strategy partner and ethics counselor that knowledgeable observers now attribute to the modern general counsel.

To avoid confusion, it is important that one officer—be it the CLO or the GC—is designated as the head of the corporate legal department and is thus responsible for the legal affairs of the entire corporation. To the extent that the CLO participates in substantial business and strategy discussions, clarity should be added to what portion of her advice is subject to the attorney-client privilege.

BRIEFING GOVERNANCE ON TRANSITION TO APMs

Health system general counsel can play an important role in encouraging appropriate board and committee level briefings on the organizational implications of MACRA and other “transformational” **alternative payment models**. The most recent governance principles commentaries underscore the importance of focused board education on developments of strategic importance.

Certainly, payment reform stands out in terms of its broad-based impact on health care systems. The need for board awareness lies in the profound change MACRA and other APMs are expected to have on health systems: *e.g.*, their physician relationships, strategic planning; mergers/acquisitions; capital budgeting and debt financing; information technology; human resources/employee benefits; quality of care and legal compliance. This suggests the need for a core level of full board training and education, with more focused training provided for individual committees whose charter responsibilities are implicated by the expected developments.

The general counsel is uniquely positioned to support this educational commitment, given the fundamental legal and regulatory implications of the payment reform; the general counsel’s role as a primary advisor to the governance committee, and the general counsel’s overall prominence within the organization.

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 August’s Published Articles & Speeches

- [The General Counsel’s New Opening to the Governance Committee](#)
- [Return of Exec Accountability Creates Compliance Challenges](#)
- [A United Effort to Overhaul Corporate Governance](#)