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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:

OVERSIGHT OF CORPORATE CULTURE

A significant emerging governance trend is the evaluation of the proper role of the board in exercising oversight of the organization's corporate culture. This effort reflects an increasing awareness of how matters of culture and reputation correlate to the success of an organization and to the board's efforts to sustain the long term mission imperatives. It also can be seen in many recent media reports on how companies are responding to challenges that implicate its culture and ethics.

The Wells Fargo board's "**Corporate Responsibility Committee,**" established several years ago, was an early and particularly prominent indicator of this trend. The Committee charter incorporates a detailed understanding of how board oversight intersects with matters of corporate reputation, sustainability, community involvement, risk management and similar cultural topics. In addition, various media outlets have reported on the leading role that the **Uber board** (and in particular, director Arianna Huffington) has taken in connection with the company's efforts to overcome recent scandals, and implement changes in key aspects of corporate culture (*e.g.*, the extent to which management allegedly fosters aggressive competition for management approval while tolerating inappropriate behavior by high performing employees). Notably, the **National Association of Corporate Directors** announced on March 28, 2017, that its 2017 Blue Ribbon Commission will explore the role of the board in overseeing its organization's corporate culture. The underlying presumption of the NACD analysis is that oversight of culture is directly related to an organization's success or failure.

Given the connection between corporate operations, ethics, compliance and risk management, the general counsel is peculiarly well-suited to advise the board on cultural oversight matters. As prominent legal observers have long noted, the general counsel is viewed as a "**guardian of the corporate reputation**." This expansive description is supported by multiple new surveys that attribute to the general counsel significant responsibilities, extending beyond the purely legal.

MAINTAINING BOARD CONFIDENTIALITY

The recent controversy regarding the **resignation** of the former president of the Federal Reserve Bank of Richmond serves to remind boards of the paramount fiduciary importance of maintaining confidentiality. It is one of the most crucial, yet perhaps least enforced, of all of the elements of the duty of loyalty.

According to multiple **media reports**, the president resigned his position after disclosing his participation in a 2012 disclosure of confidential information, a breach that ultimately prompted a criminal investigation and caused reputational damage to the Federal Reserve Bank. The underlying circumstances involved a telephone conversation with an analyst working for a policy intelligence firm. According to the former president, the analyst discussed details of confidential Fed deliberations. By continuing the conversation, the former president said he may have suggested an acknowledgment or confirmation of that information. The substance of the conversation was reported the next day in the firm's newsletter, and was described as confidential information about Fed policy initiatives. The former president also admitted to failing "to provide a full account" about his conversation in a subsequent questionnaire and interview with the Fed's general counsel in December 2012. **According to some media reports**, his resignation may have been prompted by the response of the bank's board of directors to the government investigation.

The duty to maintain the confidentiality of board discussions and supporting material is a fundamental element of the duty of loyalty. While health system directors may not occupy the prominence of a Fed official, they are nevertheless privy to extraordinarily sensitive and proprietary information relating to the business of a sophisticated financial enterprise. A leak of confidential information could in many circumstances have substantial reputational, strategic, competitive and/or financial implications to the health system. While there is a natural reluctance of boards to "punish" their own members for a perceived breach of duty, the failure to do so (especially in material circumstances) could undermine the authority of the board and raise questions as to whether the inaction itself constituted a breach of the duty of care.

THE OIG/HCCA COMPLIANCE RESOURCE GUIDE

The new **Compliance Program Resource Guide** (Resource Guide), jointly prepared by the US Department of Health and Human Services (HHS) Office of Inspector General (OIG) and the Health Care Compliance Association (HCCA) may be a helpful tool in evaluating compliance program effectiveness for many hospitals and health care organizations. However, it is neither represented to be, nor should it be considered, a "best practice" or all-encompassing template.

Released on March 27, 2017, the Resource Guide is the byproduct of the structured January 17, 2017, "roundtable" meeting of OIG staff and "compliance professionals." The stated purpose of the roundtable was "to discuss ways to measure the effectiveness of compliance programs." The roundtable discussion was focused on concepts about "what to measure" and "how to measure" with respect to all seven of the elements of compliance program effectiveness identified by the **Federal Sentencing Commission**. To make sure that all elements of a compliance program were addressed in the discussion, seven specified categories set forth in an **HCCA publication** were used as a guide. Being clear that the Resource Guide's purpose is essentially to memorialize the idea-generating discussion by the roundtable participants is important. Given OIG's participation, there is the potential for the Resource Guide to be incorrectly construed as the agency's recommendations, or even requirements, for measuring compliance program effectiveness. The document's clarity on what it is not intended to be should be helpful in ensuring the document is not used by *qui tam* relators or others as creating *de facto* compliance program requirements.

Perhaps the greatest benefit of the Resource Guide is the extent to which it serves as a catalyst for closer, coordinated consideration of the metrics by which compliance program effectiveness may be measured by legal and compliance personnel and the board—which holds the **ultimate responsibility** for determining whether the organization has satisfactorily addressed the effectiveness of its compliance program. In this regard, there is value in the general counsel teaming with the chief compliance officer to review the Resource Guide in detail, and identifying those particular elements that may be most applicable to the individual organization. Any such review should also take into close consideration the **compliance program effectiveness** metrics applied by the Department of Justice.

THE LIMITATIONS OF RECUSAL

Recent developments involving the nomination of a senior Trump Administration official serve as a reminder of both the utility of "recusal" as a means for resolving individual actual or potential conflicts of interest, and the increasing limitations of that governance device given the current external focus on duty of loyalty considerations.

The nominee has been tapped to head a large federal agency, and possesses substantial qualifications to serve in that capacity. However, through the traditional disclosure process, the **nominee disclosed** a series of substantial prior highly compensated relationships and affiliations with organizations and associations that the particular agency regulates. The nominee has pledged to recuse himself for a one-year period from matters coming before the agency that implicate any of these prior relationships, in order to reduce the impact of any conflict of interest. In addition, the nominee has entered into an **ethics agreement** memorializing that pledge. Despite those good faith efforts, the nomination has attracted some criticism—fairly or unfairly—on the grounds that the breadth of those prior relationships may be a fundamental barrier to the effective administration of the agency.

From a traditional governance perspective, this circumstance underscores the increasing focus on "recusal" as a means for mitigating the risk to a corporation when an individual director has multiple different material conflicts; *e.g.*, when a director maintains a highly visible and active role in the industry sector in which the corporation is situated. "Recusal" is the act of removing oneself as judge or policy-maker in a particular matter, especially (but not solely) because of the presence of an actual or apparent conflict of interest. It is a traditional practice that is adopted from time to time as a means for reducing the perceived impropriety of a particular director on the full board's consideration of a matter in which a director has been determined to have a financial interest or other form of conflict. However, recusal may be less effective when the extent of conflicting relationships raises fundamental issues concerning both the director's availability to perform his duties due to the frequency and extent of his recusals, and to his ability to satisfy the duty of loyalty from a broader perspective.

THE PERILS OF THE LARGE BOARD

The governance challenges associated with very large boards led by an exceptionally active executive committee are reflected in a **recent article** in *The New York Times* addressing allegations associated with the Metropolitan Museum of Art. According to the article, the charity has a core governing board of 101 members, but most of the board duties are (by necessity) performed by the executive and finance committees.

The focus of the article was on passive board oversight as it related to issues arising from an alleged relationship between the long-standing chief executive (since resigned) and another staff member, and from a senior corporate officer who departed under a confidential settlement after complaining about that relationship. These issues were exacerbated by the recent discovery of a $40 million budget deficit. The particular suggestion was that decisions relating to the alleged relationship and to the confidential settlement (including the retention of two outside law firms and a management company to advise the corporation) were made by the executive committee without the knowledge or involvement of the larger board. The article described the Museum as run by "a dozen or so executives and trustees" with limited transparency and particularly limited engagement with the majority of board members.

Corporate law does not ascribe any specific limitations on board size, and it is difficult to represent that there are any specific best practices in this regard. The general expectation is that the board will periodically evaluate the size and composition of its board in relation to the scope of board activities and the governance challenges facing the organization. In addition, it is well established that some types of charitable health care institutions feel compelled to establish very large boards in order to facilitate development needs. Unusually large boards often present governance problems associated with potentially excessive reliance on executive committee practice; limited involvement and awareness of board activities by non-executive committee members; and difficulty in obtaining quorum for meetings and votes.

It would be unfair to attribute any informed criticism of the Museum's board based solely on *The New York Times* article. The *Times* article is, however, a useful reminder to the governance and nominating committee of the need to regularly monitor the size of the board in relation to governance effectiveness, the information flow to all members of the board, and the proper use of the executive committee.

NEW DIVERSITY GUIDANCE

The health system board's nominating committee may find as a useful resource **new gender diversity guidance** released by the asset management firm State Street Global Advisors (SSGA). While the focus of the SSGA guidance was public company boards, many aspects of its discussion are directly relevant to board composition issues of large nonprofit health systems.

Leading statements of governance principles emphasize the need for board composition to reflect complementary and diverse skill sets, backgrounds and experiences. These principles view diversity along multiple dimensions (*e.g.*, race, gender, perspective, background and experience) as critical to a high-functioning board. For those reasons, the suggestion is that director candidates should be drawn from a rigorously diverse pool. The new SSGA guidance provides some useful suggestions on how best to implement these principles from the specific perspective of gender diversity. These include the identification of both specific problematic practices SSGA believes contribute to the lack of gender diversity on boards, and six specific steps that boards may adopt in order to increase gender diversity.

The general counsel can contribute to the ability of the nominating committee to address diversity matters by sharing the SSGA guidance and confirming the relevance of many of its recommendations. The meaningful consideration by the nominating committee (and the full board) of recognized methods by which board diversity can be increased will be reflective of good faith governance practices.

IMPROVING BOARD EVALUATIONS

While many health systems are emphasizing board evaluations as an important aspect of director refreshment, a **new Stanford/Rock School of Governance study** suggests that the evaluation process often falls short in several key respects—and thus may not have the full confidence of the board.

According to the study, the problem is two-fold. First, only slightly more than half of the surveyed companies (55 percent) that conduct board evaluations actually include an individual director evaluation component. Second, of those companies, only about one third (36 percent) believe that their companies effectively evaluate individual directors. These perceived concerns with the individual evaluation process are exacerbated by several other survey results that indicate director dissatisfaction with certain elements of the overall boardroom dynamic. For example, only two-thirds of the surveyed directors believe their board is open to new perspectives; only half "strongly believe" that the board takes full advantage of the skills of individual directors; less than half (46 percent) are concerned that an internal board clique dominates the discussion; and the general sense of the surveyed directors is that at least one of their fellow directors should be removed for ineffectiveness.

Full board, and individual director, evaluation protocols are increasingly important tools in the overall board refreshment process. They reflect a good faith approach to assuring productive board conduct, and have been endorsed by both the "Commonsense Principles of Corporate Governance" and 2016 edition of the Business Roundtable's "Governance Principles." When used effectively, they can alert the board to concerns about the effectiveness of the full board and of individual directors. In the absence of term limits or similar mechanisms, the evaluation process can provide a mechanism for removing underperforming directors. The study's analysis of the board evaluation process is only part of **a much larger survey** on board effectiveness, which may be of particular interest to members of the health system's governance committee.

"CONNECTED DIRECTORS" AND THE NOMINATION PROCESS

A **new academic study** provides interesting observations for the nominating committee on the appointment of directors with pre-existing relationships to the company (*i.e.*, the "connected director"). The study is timely given emphasis in **recent statements** on governance principles about nominating directors from a vigorously diverse pool of candidates.

The premise of the study is that the characteristics of the director nomination process are often undefined, and sometimes controversial to the extent that the process frequently results in the nomination of connected directors. Nevertheless, the study notes that nominating connected directors may reduce uncertainty and lower "coordination costs"; *e.g.*, it may facilitate consensus as to the nomination, reduce the learning curve often associated with assimilating new appointees into the full board, "certif[y]" the new connected directors by virtue of their past association and increase the comfort level of the new appointee. On the other hand, multiple directors from similar backgrounds and mindsets are more likely to share a similar view on particular issues as many of the incumbent directors. The effectiveness of the full board may suffer when it is unable to take advantage of candidates with differing perspectives.

The nominating committee may wish to use this study to prompt further discussion about the most effective process by which it identifies and evaluates potential directors. In order to operate in a manner consistent with leading trends and emerging best practices, nominating committees are being called upon to balance traditional concepts of competency with emerging concepts of diversity across a broad spectrum of race, gender, ethnicity, and perspective and experience. In this context, the benefits of selecting directors on the basis of existing board networks, or similar backgrounds or shared experiences, are increasingly limited—and can actually prove to be a barrier to thoughtful board discourse and analysis.

"AGE DIVERSITY" AND DIRECTOR REFRESHMENT

Another **new academic study** provides an interesting analysis of age diversity of corporate boards, particularly by demonstrating how little variation in average board age exists in leading corporations. This may be of interest to health system nominating committees dealing with issues of longstanding directors, or considering term or age limitations on board membership.

The basic premise of the study is that, in an era in which director refreshment has become an important board effectiveness measurement, matters of age diversity have been relatively ignored. Several of the most relevant survey findings include: (1) the average age of all surveyed boards was 62.4; (2) within individual boards, more than half (55 percent) were composed of members primarily in their 50s, 60s and 70s (The average director age of surveyed health care companies was 57 and those companies also had a fairly high level of age deviation on the board.); (3) directors who have served on their respective boards for less than three years were, on average, seven years younger than directors who had served their respective boards for more than 10 years; (4) the vast majority of directors with longer than 10 year tenures joined their respective boards when they were in their 40s or 50s; and (5) greater director turnover activity did not result in more age-diverse boards.

The particular value of this survey to health system nominating committees is the extent to which the data prompts a closer consideration of the various age-related factors when evaluating the most effective composition of the board; in other words, it offers a new data point for the nomination and refreshment processes. The study suggests that board composition that includes directors from different age groups enhances diversity of perspective and experience (and, thus by extension, contributes to board effectiveness). While the survey is based on **data drawn from S&P 500 companies** (including those in the health care sector), much of the survey conclusions are relevant to sophisticated nonprofit organizations.

CONFLICTS AND DIVESTMENT

The limitations of divestment as a possible means of resolving substantive conflicts issues is well demonstrated by the challenges facing several Trump Cabinet members when dealing with illiquid investments.

According to a **recent *The Wall Street Journal* report**, the particular divestment issue arises from (1) government conflicts rules that require senior administration officials to recuse themselves from matters in which such officials may have a financial interest, and (2) agreements individual Cabinet members made with government ethics officials to divest assets that raise particular conflicts issues. Nearly three-quarters of the more than $1 billion in assets that these Cabinet members are obligated to divest are illiquid in nature; *e.g.* real estate, closely held companies and interests in private equity funds.

Asset divestiture is often a means adopted by nonprofit health system boards to resolve a sustained actual or potential conflicts arising from individual director holdings. Large health systems may often have directors with sophisticated financial portfolios that frequently include a broad range of illiquid assets. When related conflicts situations arise, divestiture of the asset may be a more comprehensive solution than periodic recusal. The problem arises when the director's ability to divest the asset in a timely and reasonable manner (*i.e.*, fair price) is complicated by its illiquid nature. In such a circumstance, the board and the director may face an uncomfortable set of alternatives including (1) some looser form of conflict management response; (2) requiring the director to sell the asset even if at unfavorable economic terms; or (3) the resignation of the director. Vigorous conflicts of interest disclosure processes in both the nomination process and throughout board service can help identify potential divestiture issues in advance, and possibly mitigate related problems.

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 **www.mwe.com/peregrinepubs**.

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