McDermott Will & Emery

COMPILED WITH COMMENTARY BY MICHAEL W. PEREGRINE

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:

EMERGING NONPROFIT CONTROVERSY

Health system general counsel are well advised to monitor developments involving the scrutiny of governance and operations of the University of Louisville Foundation, the large fundraising affiliate of the University of Louisville.

On June 9, **an independent investigative report on Foundation practices** was released. The report identified, in substantial detail, information with respect to "excessive spending practices, unbudgeted expenses, unapproved actions, high executive compensation and unrecorded endowment losses." Other information related to substantial governance deficiencies and comingled financial/endowment accounts. **More recent information alleged** that Foundation officials (executives and board members) may have improperly invested their own money with companies in which the Foundation was already investing.

The **Kentucky Attorney General announced** that his office is evaluating the Foundation circumstances for possible criminal activity.

The Foundation is organized as a nonprofit organization. As such, the allegations regarding executive and board conduct within the Foundation are relevant to nonprofit hospitals and health systems, particularly given the financial and operational sophistication of the organization and the breadth of disputed actions.

OVERSIGHT OF WORKFORCE ENVIRONMENT

Recent developments suggest that boards may increasingly be called upon to exercise some degree of oversight with respect to the workforce environment, given its importance to business success, corporate reputation and mission achievement.

Prominent among these developments was the board response to public allegations of employee harassment, discrimination and retaliation within a well known ride-sharing company. The board accepted a **series of recommendations of outside counsel** meant to address these concerns. These included the creation of an "ethics and culture committee," the purpose of which is to oversee the company's efforts and enhance a culture of ethical business practices, diversity and inclusion within the organization. The committee is expected to apply performance metrics tied to improving diversity, responsiveness to employee complaints, employee satisfaction and compliance.

These circumstances arise in the context of a broader national governance focus on board responsibility to seek diversity amongst its membership, and to exercise more direct oversight with respect to matters of corporate culture. Effective governance may thus benefit from intra-board dialogue on the value of, and the method to implement, more direct oversight of workforce environment matters.

THE DISTRACTED DIRECTOR

Board governance committees may wish to increase their focus on how outside business interests may impact the attentiveness of independent directors. This may become an important element of director "refreshment" protocols.

A **recent academic commentary** argues for broader restrictions on the outside obligations of independent directors, in order to assure greater attentiveness to their board responsibilities. Such restrictions would extend beyond the traditional focus on multiple board service, to examine the impact of events at independent directors' employing firms on attentiveness. The specific concern is that independent directors [naturally] give priority to their jobs, and that poor performance of their employing firms, and other material developments, can significantlly distract those directors to the detriment of the faithful performance of their board duties.

Such "director distraction" can be difficult for governance committees to measure, at least on a "real time" basis. The committee may benefit from a dialogue on how best monitor and address indications of distraction.

SUPPORTING BOARD ASSESSMENTS

Given the increasing **external focus on director effectiveness**, the general counsel can be a strong advocate for more effective board assessment programs.

Much of this focus is being driven by new governance principles that seek to increase the contributions of individual directors, and the board as a whole, toward more engaged and productive governance. It also relates to the productivity of the director nomination process and to the development of director refreshment policies. The concern is that with many companies, board assessment programs are limited in scope or otherwise less than robust.

Supporting the effective use of governance self-assessment tools is consistent with the general counsel's role as a primary governance advisor to the board. It is also timely, given the upcoming 15th anniversary of the Sarbanes-Oxley Act and its focus on corporate responsibility.

ROLES OF GOVERNANCE VERSUS MANAGEMENT

The **potential for "business disruption"-type risk** is perhaps the latest in a series of developments with the potential for blurring the distinction between governance and management, and creating uncertainty as to the authority of the CEO.

Perspectives on "business disruption" are widespread in the current strategic business and corporate governance literature. The concept focuses on how new, well-capitalized and innovative market entrants (and especially new technology) can drive extraordinary changes in the business model of large "legacy" companies, and threaten their long-term sustainability. Think Netflix, Uber/Lyft and Amazon, and their impact on traditional competitors.

Both directors and executive leadership are becoming much more aware of the impact of business disruption on the company’s strategic direction. Directors see the task of responding to business disruption as the primary responsibility of governance, given its link to strategic corporate direction and long term sustainability. Senior executives view the task as inseparable from their day-to-day management responsibilities of responding to competitive forces.

In these circumstances, it is likely that both sides are right. But in order to avoid unnecessary internecine conflict, the board and executive leadership should engage in direct dialogue designed to identify the most effective means—perhaps shared—by which the organization can identify and respond to business disruption risks. The general counsel is well suited to "broker" this dialogue.

AG CHALLENGE TO MANAGEMENT OF AFFILIATE

The **New York Attorney General's challenge** to the appropriateness of management services provided to a nonprofit senior living facility was recently **rejected by the New York Supreme Court**.

The litigation was styled by the Attorney General's Charities Bureau as an action to remove the senior executives and board members of the company that managed the nonprofit facility. The **state's allegations** related to the executives "maintaining a stronghold over [facility] operations in violation of law." This included conflict of interest allegations that the senior executives pursued the sale of affiliated facilities in order to achieve a bonus. The state court judge dismissed virtually all of the Charities Bureau arguments, expressing criticism with the absence of facts demonstrating improper conduct.

This litigation is noteworthy for two reasons. First, it demonstrates the willingness of charities officials to examine the nature of, and intervene in, contentious parent- or manager-affiliate relationships. Second, it is an example of how state scrutiny can be prompted by a whistleblower (in this case, the volunteer president of the resident's association).

ACC SURVEY

Members of the senior leadership team and the Audit & Compliance Committee would benefit from an overview of the results of the **Association of Corporate Counsel's most recent annual "Trends Report."**

The 2017 edition of the survey focused on three classes of trends: first, the substantive legal and business issues that confront in-house counsel on a day-to-day basis (*e.g.*, compliance, regulatory and cybersecurity, and changes in company policy necessitated by those issues); second, professional and ethical issues that appear to be most impactful on the in-house counsel experience (*e.g.*, privilege, the hierarchical status of in house counsel, and the dynamic between inside and outside counsel); and third, matters relating to job satisfaction, mobility and compensation. These matters also include human resources issues involving in-house counsel that are gender-related (*e.g.*, continuing pay disparity).

The effectiveness with which senior executive leadership and the board and its key committes work with, and support the role of, the general counsel would be greatly enhanced by reviewing the ACC report. By increasing the awareness of these leaders of issues affecting the role of in-house counsel, they may have a more informed perspective on the role and function of the legal department.

NEW COMPLIANCE PROGRAM SURVEY

The health system's Audit & Compliance Committee may benefit from a briefing on the highlights of a comprehensive **new global survey** on compliance programs.

Several of the survey's results are notable: (i) the number of compliance officers concerned about their personal liability is decreasing (although it is still high); (ii) an increasing number of compliance officers are satisfied with their available resources; (iii) significant concern exists with respect to the frequency and content of compliance-to-board reporting; and (iv) less than half of surveyed companies do not penalize employees for failing to participate in required compliance training.

This new survey is not focused on the health care industry and it does not address the continuing challenge of proper coordination between compliance and legal functions. Nevertheless, the survey's results are sufficiently detailed as to serve as a useful resource to the Committee.

SPOTTING "RED FLAGS"

The increasing expectations associated with exercise of the director's oversight obligation are highlighted in a recent ***The Wall Street Journal* article** concerning Theranos and board oversight of corporate operations.

Based on a review of depositions given by the two former directors, the article suggested that they had failed to follow up on public allegations that the company was using standard technology in its blood testing operations, rather than its touted proprietary technology. The article's inference (fairly or unfairly) was that these allegations were a "red flag" regarding the company's emerging financial, regulatory and reputational problems—and that the board should have responded to the information.

Twenty-twenty hindsight of director conduct can be quite unforgiving. The law provides no clear cut definition of "red flag." Knowledgeable **observers have described it** as "...information that alone or in combination with other known information presents the board with an immediately known duty to act." The general counsel can provide significant value by providing the board with practical guidance on the range of circumstances that might reasonably be considered "red flags."

OBSTRUCTION OF JUSTICE

The ongoing media coverage of possible "obstruction of justice" by government officials has significant relevance to the corporate sector, including hospitals and health systems, and their employees, officers and directors.

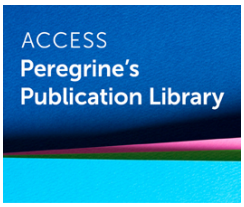
As a **recent article in *The New York Times*** notes, the federal criminal code includes many different laws that address different types of obstructive conduct. For example, Section 802 of the Sarbanes-Oxley Act makes it a crime to corruptly obstruct, influence or impede any official proceeding, or attempts to do so (including document destruction, cover-up and falsification). Section 802 was intended to prevent conduct similar to document shredding by an accounting firm of audit-related documents in the Enron controversy. This is one of the several provisions of the Act that is applicable broadly, including to nonprofit corporations.

Many health systems incorporated obstruction/document destruction prohibitions within their codes of ethics following Sarbanes. The current controversy regarding possible obstruction offers a timely opportunity to "dust them off," and remind a new generation of corporate employees and fiduciaries of those prohibitions.

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**.

PEREGRINE'S PUBLICATION LIBRARY: A NEW GOVERNANCE RESOURCE FOR GCs



Michael Peregrine's extensive library of articles on health care corporate law and governance is now available as a new resource to McDermott clients.

Peregrine's Publication Library provides readers with up-to-date access to more than 300 articles that can be filtered by subject matter, covering a range of topics such as core principles of governance; conflicts and independence; board composition; board conduct and engagement; corporate structure and streamlining; committee practices; emerging governance developments; oversight of risk and compliance functions; and issues pertaining to the Office of the General Counsel. The Library also provides direct access to prior issues of *Corporate Law & Governance Update* newsletter and episodes of the *Governing Health* podcast series.

We hope this resource will streamline access in any instance where General Counsel may need to efficiently provide governance resources and support to Management and the Board, and alleviate any pressure to scan through countless emails to locate previously shared material.