McDermott Will & Emery

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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:

CONFLICTS OF INTEREST

As the daily headlines make clear, issues associated with governance conflicts of interest are very much "on the front burner" and the focus of media scrutiny. These types of issues typically incorporate not only duty of loyalty concerns, but also other key legal and tax considerations relevant to the board's decision making process (and to the sustainability of specific board actions).

In that context, the recent **National Association of Corporate Directors publication, "Avoiding Conflicts of Interest,"** is worthy of attention by the health system governance committee. The publication (written to apply to directors of both for profit and nonprofit companies), sets forth a series of basic principles regarding the duty of loyalty and director obligations with respect to the identification, disclosure and resolution of conflicts of interest. Included within the publication is a set of "Key Questions for the Board" with respect to compliance with elements of the traditional conflicts protocol, and a series of related action steps designed to increase attentiveness to conflicts matters. As such, the publication serves as a credible supplement to advice the general counsel and the compliance officer are likely already providing the board with respect to the conflicts review process.

In this regard, it is important to recognize that for nonprofit corporations, the types of relationships and arrangements that are traditionally associated with conflicts of interest also implicate a series of other, related governance and regulatory requirements that may require attention—and each of which applies a different legal standard or definition. Careful coordination of these differing standards to the requisite facts is necessary in order to assure compliance with applicable law.

Click here to access the new McDermott video, "The Conflicts of Interest Puzzle: Key Guidelines for the General Counsel."

DEVELOPMENT FOUNDATION ACTIVITIES

Recent controversy involving the investments and other activities of a university-affiliated development foundation may serve as a prompt for health system board leaders to assure the appropriate legal, compliance and internal audit support of any system-affiliated development foundation.

The university foundation was the **subject of an investigative media report** that was critical of the actions of the foundation in acquiring a majority position in a former factory facility from its owner, a prominent university donor. While the expectation appeared to be that the acquisition would generate substantial

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financial benefits to the foundation, the transaction was ultimately undone after the foundation had been unsuccessful in its efforts to sell the factory. The focus of the report was on both the diligence and related process applied by the foundation in deciding to enter into the transaction, and on allegations that the actual goal of the transaction was to facilitate certain tax planning strategies of the seller/donor.

The accuracy and perspective of such investigative media reports are often subject to question. Nevertheless, the extent of the coverage and the nature of the allegations themselves can be a useful reference point for health system leaders. The value of organized fundraising activities notwithstanding, the separate fundraising and asset investment corporations supporting (and under the control of) the health system should be subject to the same legal, compliance and accounting oversight as all other controlled corporations in the system, particularly with respect to the unique charitable registration and solicitation, charitable trust and exempt organization tax issues to which such foundations are subject.

THE "FIT FOR SERVICE" BOARD

A new publication from the **National Association of Corporate Directors (NACD), "Building the Strategic Asset Board,"** provides useful lessons to nonprofit health system boards as they work to maintain their ability to respond (in terms of size, composition, expertise and commitment) to the velocity of change in the health industry. In essence, it is a call for formal "continuous improvement" processes at the board level.

NACD does not view traditional board refreshment efforts (*e.g.*, tenure and age limits) as sufficient to position the boards to respond to evolving industry dynamics. Rather, its recommendation is for the board to pursue a more proactive approach that incorporates the following actions, among others: (a) continuous improvement of board and individual director skills and boardroom processes; (b) supporting the director recruitment process with an awareness of expected board competency needs; (c) a more regular review and update of governance principles; (d) coordinating the director recruitment process with the length of the organization's strategic plan; (e) more aggressive board education requirements; (f) more frequent evaluations of board, committees and individual directors; and (g) specific and regularly updated written expectations regarding director renomination.

NACD's approach contemplates a more holistic, aggressive means for positioning boards to respond to industry change. As such, it may be worthy of governance committee consideration.

***CAREMARK* DUTY UPDATE**

A **new decision of the Delaware Court of Chancery** provides what a leading legal commentator described as an "exemplary" explanation of the *Caremark* standard, and of the requirements that must be satisfied before directors can be held to have violated their duty to exercise oversight of corporate compliance programs.

The decision arose from a claim that the directors of a financial services organization breached their oversight duties by their alleged failure to appropriately monitor the company's check cashing services (and, in particular, compliance with applicable federal money laundering laws). The Court of Chancery concluded that the plaintiffs failed to meet the *Caremark* "bad faith" pleading standards. Of particular interest to the health system general counsel is the opinion's discussion of the elements of board inaction that must be present in order to demonstrate a violation of the oversight duty. According to the court, the plaintiff's core factual allegations amounted to "yellow flags of caution" as opposed to "red flags of illegal conduct." The general counsel may also find interesting—and relevant to health care compliance—the court's evaluation of the board's attentiveness to regulatory enforcement efforts in the check cashing services industry.

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 a 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.

DIVERSITY OF PERSPECTIVE

Diversity in board composition can extend beyond matters of age, gender and race to multiple other dimensions, including those of background and perspective. This is well demonstrated by the recent appointment of a highly regarded public health reform activist to the board of a consumer products company, **as discussed in *The New York Times***.

As nonprofit health systems and other charities grow in size and scope, and interact more regularly with social and policy agendas, "diversity of perspective" may become an increasingly valuable director recruitment goal. In fact, the selection of directors with non-traditional backgrounds and perspectives may serve as means for assisting the corporation to achieve certain transformative objectives consistent with its core mission.

To assure the effectiveness of these appointments, several steps are recommended: First, the proposed new director should be fully briefed on the scope of the corporation's business affairs and its mission. Second, the areas of potential or actual conflict should be identified on a broad scale, for both the corporation and the new director's own constituencies. Third, the expectations of what the new director's perspectives will bring to the board should be articulated—both to underscore the perceived benefits and to avoid suggestions that the appointment was mere "window dressing." Fourth, there should be clarity on the duty of loyalty obligations; that regardless of the new director's background, he or she must act in the best interests of the corporation.

INVESTMENT COMMITTEE UPDATE

Investment committees responsible for oversight of, and investment decisions with respect to, system retirement plans should be briefed on **new Department of Labor fiduciary duty regulations** regarding conflict of interest. The new rules, effective **April 10, 2017**, are designed to ensure that retirement investment advice will be treated as coming within a fiduciary relationship.

The existence of a fiduciary relationship between the committee and an investment advisor (*i.e.*, the provision of "fiduciary investment advice") can often supplement the prudence of committee oversight and decisions. Yet in some situations, it is conceivable that investment committees assume the existence of such a relationship when one may not actually exist. Under current ERISA rules, "fiduciary" is broadly defined to include persons who provide investment advice for a fee, regardless of whether that fee is paid directly by the customer or by a third party.

Under the new regulations, fiduciaries to retirement plans are required to act impartially and provide advice that is in their clients' best interest, not their own. In addition, these same fiduciaries are not permitted to receive payments creating conflicts of interest unless those payments comply with conditions (required by a "prohibited transaction exemption") designed to minimize the potential effects of a conflict.

In anticipation of the new regulations, the investment committee may wish to team with the general counsel to evaluate whether existing service agreements with identified investment advisors currently meet the standards to be applied after **April 10**, and, if not, to determine what changes are necessary to satisfy those standards. This evaluation would likely examine the contractual relationship with the advisor and the actions of, and specific nature of the communications from, the advisor to the committee.

STRATEGIC PLANNING COMMITTEE UPDATE

The Strategic Planning Committee should be made aware of three important legal developments arising in October that may have direct implications on the organization's strategic plans with respect to physician integration and M&A activity.

The first of these developments is the October 14, 2016, release by **CMS of its highly anticipated final rules under MACRA**, which establish the new Medicare payment methodology for physician services furnished under Medicare Part B, known as the Quality Payment Program (QPP), and will be effective beginning **January 1, 2017**. While this new methodology applies to payments beginning in CY 2019, reporting for the first year of the QPP begins in 2017.

The second development is the October 27 **speech by the FTC's Bureau of Competition Director** on hospital acquisitions of physician groups. The FTC has traditionally focused on hospitals' acquisitions of other hospitals or physician group acquisitions of other physician groups, both types of combinations being of "horizontal" competitors. But, in this new speech, the FTC is now signaling that it will take a greater interest in "vertical" combinations of different types of providers, such as acquisitions of physician groups by hospitals.

The third development is the October 31 **decision of the Seventh Circuit Court of Appeals**, overturning a prior district court decision against the FTC in the Advocate/North Shore merger case. The Seventh Circuit ruled that the District Court had committed clear error in how it defined the geographic market in which to analyze proposed merger's impact and remanded the case back to the District Court. This ruling is another victory for the FTC's hospital merger enforcement program and, together with its recent appellate victory in the *Penn State Hershey* case, is a strong endorsement for the FTC's focus on narrow geographic markets.

COMPLIANCE COMMITTEE UPDATE

The October 20, 2016, joint **DOJ/FTC release, "Antitrust Guidance for Human Resources Professionals,"** underscores the need for broad-based compliance programs that address all of the health system's material regulatory challenges, not just those related to Medicare/Medicaid reimbursement, and fraud and abuse.

The agencies issued the Guidance to educate HR professionals about how the antitrust laws apply in the employment context. Their policy concern is the risk for harm to workers if companies that would ordinarily compete against each other to recruit and retain employees instead agree to fix wages or other terms of employment, or enter into so-called "no-poaching" agreements by agreeing not to recruit each other's employees. The Guidance comes in the wake of several wage-fixing and no-poaching investigations and lawsuits in a variety of industries, including health care, by both the government and private plaintiffs.. It makes clear DOJ's intention to **criminally investigate** naked no-poaching or wage-fixing agreements that are unrelated or unnecessary to a larger legitimate collaboration between the employers.

In addition to the Guidance, the DOJ and FTC also issued an accompanying document entitled *Red Flags for Employment Practices*. This non-exhaustive guide lists scenarios that should raise antitrust concerns for managers and HR processionals.

This important new release should encourage the Compliance Committee to assure that the compliance program specifically addresses antitrust concerns across the spectrum of organizational conduct.

LESSONS FROM BOARD SURVEYS

Three new governance surveys prepared by outside consultants and released in October offer particular lessons to boards of sophisticated nonprofit health systems on a broad variety of commitment, service, performance and other relevant governance topics.

For example, **a new survey by the national accounting firm BDO USA** indicates that a substantial number of director/respondents supported specific, stringent limits (*e.g.*, less than five) on the total number of outside company boards on which a director may serve. In addition, a **separate survey published with a group associated with Spencer Stuart** reported a substantial gap between the oversight expectations placed on corporate governance, and the actual ability of a board to exercise oversight over the organization. Other relevant results from the Spencer Stuart survey included an acknowledgment of the increasing preparation requirements being placed on board members, and the value of recruiting director candidates with strategy experience.

The annual **Corporate Directors Survey from the consulting firm PwC** identified several governance trends of relevance to health systems, including the need to identify and "call out" underperforming directors; the need to expand the pool of director candidates to include qualified candidates at levels below the executive suite; the value of moving beyond the recommendations of fellow board members as the primary source of identifying potential director candidates; a gender-based "disconnect" between male and female board members on the value of board diversity; a lack of concern with increasing director workload; and an interest in spending more director time and attention in (and avoiding complacency with respect to) CEO succession planning.

Many of the leading director surveys reflect data gleaned from public company directors, whose experiences can be substantially different from those of nonprofit directors. However, given the increasing size, scope and complexity of the nonprofit health system, the instances in which there is consistency of experience are becoming much more common. For that reason, the leading results of these three surveys may be worthy of note by the health system governance committee.

"ADVANCE RESIGNATION"

Recent media stories have reported on how several senior corporate executives, recently separated from their positions due to corporate controversy, have announced their resignation from outside corporate boards. This serves as a reminder to the governance committee of the benefit of "advance resignation" policies.

The concept behind these policies is to allow the governing board the option of continuing the board service of a sitting director who either changes employment status from that which was held when he or she was nominated to the board, or has been exposed to some form of corporate or legal controversy that could reflect on his or her continuing fitness for service on the board. The policy mechanism requires each director to submit a signed resignation upon the occurrence of certain change of status or circumstance events articulated in board policy. The board or governance committee then has the option of accepting or declining the resignation, as may be in the organization's best interests. The drafting challenge is identifying the specific “status/fitness-level events” that require notification broadly enough to protect board/corporation interests.

Certainly, advance resignation and similar policies can appear somewhat harsh and insensitive. Yet the expectation is that such policies offer benefit by avoiding the difficulty in asking for a resignation, or pursuing a removal, in difficult, fitness-based circumstances (which can certainly arise from time to time). By building into governance policies a mechanism that mandates notification to the board of the occurrence of a status/fitness-level event, the board (and the organization) can be protected against the potential reputational harm associated with having a standing director involved with substantial controversy. It also allows the board the opportunity to retain the director where the circumstances warrant.

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 October’s Publications

- New Video | Conflicts of Interest Puzzle
- Has “Compliance” Had its Fifteen (Years) of Fame?
- Corporate Board Diversity Gets Push from Business Leaders
- Engaging Board and Corporate Leaders About New Avenues for Officer and Director Exposure Under the Stark Law and False Claims Act