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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:

THE #1 FIDUCIARY DUTY ISSUE OF 2017

Positioning boards to exercise heightened engagement within the current "climate of uncertainty" is possibly **the most important health system governance** challenge of 2017. To adequately address this challenge will require an extraordinary commitment of time and energy by the board.

This "uncertainty" extends beyond the fate of the Affordable Care Act to an increasingly volatile political climate and global economy, all of which present enterprise risks to health care organizations. Health system directors should maintain a sharper awareness of how issues like border security, immigration restraints, trade conflict, regulatory reform and significant market fluctuation affect the health system. Would a Dodd-Frank rollback have spillover effects? Could administration pressures on certain key industries expand to include health care? Will the new US Supreme Court justice influence upcoming rulings on health care-related cases?

The necessary level of engagement can be manifested in several ways. The most obvious way is by increasing the amount of time devoted to the board agenda. A second, related way is by being fully informed on political, economic and regulatory developments of relevance to the system and its business model. A third way is by repositioning the composition and structure of the board to assure responsiveness to these and similar developments. A fourth way is fulsome understanding of the board's role as a "partner" to the executive management team. Such heightened engagement will directly support the director's performance of his or her oversight and decision-making duties. The general counsel can help coordinate executive team support to the board as it seeks to address the need to increase engagement.

CLOSER SCRUTINY OF BOARD CONFLICTS

Political biases aside, the transition process for the new administration—both as to President Donald Trump and to his Cabinet nominees and White House advisers—does a great service for nonprofit health systems by highlighting critical conflict of interest concerns.

Recent headlines over the last month provide health system general counsel with a rare opportunity to offer practical board education based on current events. The president's personal asset divestiture plan, announced on January 11, along with the broader public scrutiny of key administration members' business and investment interests, present an important teaching moment on identifying,

resolving and managing conflict of interest issues. At the same time, the concern is that this coverage also serves to heighten the sensitivity of regulators, the media and constituent groups to how conflicts of interest are addressed at a corporate board level.

Neither the particulars of the administration's potential conflict issues nor the details or adequacy of the president's divestiture plan are necessarily the subject of board education. Instead, the basic nature of the issues themselves provide something of a checklist that can help health system boards ensure that their internal conflict of interest policies and processes are as fulsome as possible. The issues also warrant greater board education on the scope and strictures of the core duty of loyalty. As the general counsel is well aware, strong conflict of interest protocols are increasingly critical to protecting the reputation of the organization and its board members, and to sustaining key business arrangements.

EFFECTIVE USE OF COMMITTEES

An interesting **new survey** on board committee practice from a major accounting firm provides useful fodder for governance committee consideration. This is especially the case as some health system boards apply a committee structure that may be insufficiently responsive to current operational, financial, strategic, technical and legal challenges facing the organization.

Several aspects of the survey results may draw particular governance committee attention. For example, a significant majority of surveyed companies are adding to the overall roster of committees, typically in response to evolving board agendas, new governance pressures and priorities, and operational, legal and other environmental challenges. Also, the most responsibility delegated from the board is extended to the executive, audit, finance, compliance and risk committees. In addition, the compliance, risk and technology committees have seen the most growth in the past three years (in terms of creation as a separate body). There is also a recognition that certain emerging functions (*e.g.*, cyber, digital transformation and information technology) should not automatically be assigned to the audit committee but may deserve their own committee.

From a health system perspective, perhaps the greatest value of this new survey is the prompt it provides to revisit the sufficiency and effectiveness of the board's existing committee structure. With guidance from the general counsel, the committee might prudently address such questions as whether (a) the board's committee structure remains appropriate given current board priorities and system-specific needs; (b) the board is sufficiently familiar with relevant best practices, and peer company approaches, as to committee oversight responsibilities; (c) the results of board effectiveness assessments reveal governance problems that might be resolved with changes in committee structure; and (d) a more proactive committee practice could enhance board refreshment and oversight goals.

CONTINUING "GATEKEEPER ANXIETY"

Multiple recent developments suggest that governing boards will continue to be called upon to address the **personal liability concerns of corporate gatekeepers** and other executives. These new developments indicate that the "pipeline effect" of investigations commenced after the Yates memo was issued in September 2015 will be felt for the foreseeable future.

The likelihood of a Yates carryover effect was first referenced by former Deputy Attorney General Sally Yates in her **November 30, 2016, speech**. She noted that a significant number of corporate investigations that began after issuance of the Yates memo will not result in public filings until well into the new administration. In those investigations, prosecutors have been evaluating whether any individuals should be subject to criminal or civil penalties. As Yates said, "I expect that, in coming months and years, when companies enter into high-dollar resolutions with the Justice Department, you'll see a higher percentage of those cases accompanied by criminal or civil actions against the responsible individuals. It won't be every case, but the investments we're making now are likely to yield a real increase in the years ahead."

As Yates predicted, a flurry of notable DOJ enforcement activity with individual accountability components became public in the early weeks of 2017. This activity is likely to fuel the self-interest tendencies of many key corporate leaders. That, in turn, could enhance the potential for conflict between the board and individual executives across a broad spectrum of organizational initiatives; *e.g.*, the pursuit of strategic projects, compliance with organization policies and cooperation with internal investigations. The board will be

expected to mollify these concerns, as it has since the Yates memo was issued. Yet, if not planned for, that task could easily become an unwanted distraction from more pressing board responsibilities.

THE FTC AND OVERLAPPING BOARDS

Important **new guidance** from the Federal Trade Commission (FTC) underscores the value of antitrust compliance when health systems use interlocking officers and directors, and other overlapping governance relationships, to establish collaborative arrangements.

This guidance took the form of a January 23, 2017, public release, "Have a plan to comply with the bar on Horizontal Interlocks," issued by Debbie Feinstein, Director of the FTC's Bureau of Competition. Interlocking director and officer arrangements are a popular affiliation model in health care. They are used by some health care systems to foster collaborative arrangements, and to facilitate governance connections between organizations that are loosely connected by common sponsorship, charitable purposes or religious affiliation but are not under common control or ownership. They also arise in acquisitions involving less-than-control positions.

The antitrust concern (Section 8 of the Clayton Act) arises when the collaborative arrangements that involve interlocking relationships are created between organizations that the government could reasonably consider to be "competitors." That is not always an obvious circumstance, given the variables of the law, and the nuances of particular collaborative arrangements. Given the often (seemingly) innocuous nature of interlocking relationships, the antitrust considerations may not always be apparent to corporate strategic leaders or external planning consultants. Thus, the new FTC guidance offers a timely opportunity for the health system general counsel to discuss the antitrust risks that can arise from interlocks, and the best ways to identify concerns that may be presented by particular proposals.

STRATEGIC PLANNING BARRIERS

A **recently published article** identifies, in a practical manner, a series of common barriers to a board's ability to exercise oversight over the strategic planning process. This is useful information given the increasing pressures placed on long term strategy development by the current environment of political, economic and regulatory volatility.

Six particular barriers have been cited by the National Association of Corporate Directors (NACD). Most prominent among these was not having enough time in meetings for strategy discussions, despite the increase in overall director time commitments to board service. Two related barriers were (i) the difficulty in confirming the validity of assumptions set forth in support of particular strategic directions; and (ii) lack of an "honest" set of performance metrics from which observations on corporate progress may be derived. Another notable barrier cited by NACD was too much focus, in terms of information flow, on past results and lagging indicators, and not enough focus on trends and forward-looking indicators. Not surprisingly given current developments, another cited barrier was lack of understanding of how the current industry or business environment affects strategy. The final cited barrier was the pressure on the planning process arising from an excessive focus on short term performance, as opposed to long term sustainability.

Many leading governance indicators are calling for increased board involvement in the identification of strategic issues facing the corporation, in the development and implementation of the strategic plan, and in the close monitoring of the strategic plan. This is particularly important given concerns that the "shelf life" of strategic plans is increasingly shorter, given the evolution of the health care industry. The general counsel is well-qualified to advise the board on its fiduciary obligations in this regard.

OFFICE OF ETHICS COUNSELOR

One of the unanticipated side effects of the intensive focus on President Trump's personal conflicts issues is increased interest—and in some cases actual application—of a new corporate position of "chief ethics officer." Yet the wisdom and practicality of creating such a separate hierarchical position within a corporation requires careful and dispassionate board-level review, in consultation with the general counsel.

The ethics of the corporation, and of its officers and directors, are grounded in principles of corporate responsibility and in Sarbanes-era concepts of ethical codes. In most large corporations, the question has usually been less of whether to assign ethics oversight to a particular officer, and more with

respect to which officer should the responsibility be assigned. The debate over responsibility for corporate ethics has long been sharp, with compliance officers claiming it as a logical extension of their duties, while the general counsel pointing to the rules of professional responsibility and academic reports that specifically mandate lawyer responsibility for advising clients on ethics matters.

All of this is now coming to the forefront, in connection with the President's divestiture efforts. For example, The Trump Organization recently hired a prominent attorney to serve as the company's outside ethics advisor—particularly in connection with the ethics walls intended to separate the President from Trump family business interests. In addition, it reassigned an existing corporate official to serve as compliance officer, with the responsibility for monitoring internal conflicts. At the same time, the White House appointed an internal advisor (serving under the White House Counsel) with responsibility for monitoring ethics concerns of the President and White House advisors.

The attention ascribed to these developments could potentially prompt a new, if subtle, push within companies to create similar ethics positions, especially given the intense public focus on conflicts and ethics during the recent transition process. Yet, the role of a separate ethics officer has the potential for further confusing the distinctions between internal gatekeepers, as it relates to matters of legal compliance, conflicts of interest and operational and financial ethics of the organization.

NO NEED TO WAIT FOR FIDUCIARY RULE OUTCOME

Health system boards, investment committees and officers with fiduciary responsibilities will be interested in **recent developments** regarding fiduciary standards for employee retirement plans.

In early February, the Trump administration directed the Department of Labor (DOL) to study a new fiduciary rule proposed last year (and scheduled to become effective this April) significantly impacting retirement plans governed by ERISA, and to rescind or revise the rule if it is not consistent with the administration's regulatory principles. The proposed fiduciary rule greatly expands who is considered a fiduciary and imposes new responsibilities for all plan fiduciaries. While the fate of the new rule remains unknown, its impact has already been felt in the marketplace of financial service providers to retirement plans, as some have embraced fiduciary status and changed the way that they price their services. At a minimum, this changed marketplace has raised fiduciary risks associated with selecting among service providers with varying fee structures.

Establishing a solid fiduciary governance structure and a process through which fiduciary decisions are made are essentials for modern day retirement plan management and should not await a decision on the DOL's proposed fiduciary rule. In fact, prudent plan governance may become even more important in the new marketplace for financial service providers. In addition, the current spate of litigation instituted against plan sponsors in the non-profit sector for fiduciary breaches arising from service provider fees provides notice that fiduciary decisions are being monitored by a cottage industry ready, willing and able to bring a law suit to "protect" employees' retirement assets. Accordingly, health system boards, investment committees and officers with fiduciary responsibility would be well served to review the documents (plan and trust documents, contracts and investment policies) that serve to guide fiduciary decisions.

THE CRISES BOARDS SHOULD LOOK FOR

An **informative new article** in the *Harvard Business Review* addresses the risk of what the author describes as "ungoverned incompetence." This risk arises when "someone does the wrong thing while trying to do the right thing, and organizational systems fail to catch it and contain it"—as opposed to more recognizable situations where the organization is harmed because of executive level malfeasance.

Three specific characteristics are cited as the most likely causes of "ungoverned incompetence." *First* is the "collapse of competence": when executives assume challenges that are beyond their capabilities to address. This can happen when the operating environment changes in ways the executives do not recognize, or they take on a project or initiative that they assume is within their capacity to address, when in fact it is not. *Second* is "shortcomings in self-governance": when an executive is operating out of his or her depth and fails to notice it and to seek help. This situation can arise when the executive is encouraged (by hubris, denial, defensiveness, etc.) to act against their rational interest. *Third* is "inadequate corporate governance": when critical information that

identifies the possibility of failure is either (a) not passed from the management level to the board (either through a limited agenda or ineffective reporting systems); or (b) is delivered to the board, but the board lacks the skills to properly interpret the information.

The article's premise is that such ungoverned incompetence becomes more likely as the organization assumes strategic risk due to innovation, M&A activity or an increasingly volatile business environment. As such, it serves as a very practical "duty oversight" lesson for health system governance—how key board committees can more capably recognize the warning signs of operational, financial or legal risk.

BOARD REFRESHMENT

The health system governance committee would benefit from a general counsel briefing on the relevant-to-nonprofit highlights of the detailed new survey, "**Board Refreshment Trends,**" published by Institutional Shareholder Services (ISS). Many of the survey results and analysis would be useful to health system efforts to evaluate the effectiveness of various refreshment tools.

Three aspects of the survey findings are of particular relevance to nonprofit health systems. First is the information relating to board tenure; *e.g.* average length of service; the potential for a "gender tenure gap" that should be managed by the board; the board aging process; the distribution of age levels within the board; the potential for/benefit of structured generational shift in board composition; the practice of adding new directors on an annual basis; and steady but slow gains in diversity. Second is information relating to the popularity and effectiveness of the limited options available to implement director refreshment; *e.g.*, mandatory retirement age (typically in the 72-75 year range); term limits (still relatively rare); and board evaluations (more widespread, if not disparately used). Third is other governance practices that can have a meaningful impact on refreshment goals; *e.g.* extending tenure through service on board committees, increasing levels of director independence levels (which may receive renewed attention with the 15th anniversary of Sarbanes-Oxley) and changes in board size (*e.g.*, increasing size to accommodate new members of racial, ethnic, background and perspective diversities).

The ISS survey will be particularly helpful to the governance committees of financially sophisticated nonprofit health systems, especially in the absence of any detailed and reliable board formation and director refreshment survey information on peer organizations.

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**.

Highlights of Recent Publications

- Governing Health Podcast Series: Preparing for Change in Washington
- The Top Governance Challenge For Health System Boards
- Board Forecast: Continuing Gatekeeper Anxiety
- President Trump, Potential Conflicts and Health System Boards

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