

CORPORATE LAW & GOVERNANCE UPDATE

A monthly briefing
for Health Care
General Counsel

Compiled with
commentary by
Michael W. Peregrine

The following developments from the past month offer guidance on corporate and governance law as they may apply to health care organizations:

NEW AG ACTION FOCUSES ON CHARITABLE PURPOSES

New legal action by the Pennsylvania Attorney General against a prominent nonprofit health system is grounded in allegations of violation of charitable purposes.

The Attorney General's petition seeks to amend existing consent decrees that govern the relationship between the health system and a hybrid health care insurer and provider, on the grounds that the health system violated its public charity obligations. The petition seeks to enable open and affordable access to the health system services and products through negotiated contracts with any health plan.

The Attorney General's petition appears to be grounded in two core allegations: first, that the health system is withholding access to patients in a particular geographic area whose employers have agreements with a health plan that competes with the health system, and second, that by refusing to negotiate "reasonable payment terms with self-insured employers," the health system is receiving "unjust enrichment through excess reimbursement for the value of its services." The health system has challenged the authority of the Attorney General to modify the consent decrees.

The broader significance of the Attorney General's action lies in its reliance on the general charitable purposes of a nonprofit organization and its status as a charitable institution "developed through decades of public donations, tax exemptions and debt financing" to allege that certain business practices essentially are violative of the consent decrees. The state's petition contains a lengthy recitation of how the health system's actions allegedly departed from "its obligation to satisfy all of its obligations to the public, not only those that further its commercial goals."

Much like the New York Attorney General's litigation involving Lutheran Care Network, the Pennsylvania Attorney General's action is worthy of close attention by large, diversified nonprofit health care systems.



NEW USURPATION OF CORPORATE OPPORTUNITY DECISION

A new **Delaware Chancery Court decision** underscores the importance of the duty of loyalty provision that prohibits usurpation of a corporate opportunity.

The doctrine of corporate opportunity prohibits a corporate officer or director from personally pursuing a business opportunity if (1) the company is financially capable of pursuing the opportunity; (2) the opportunity is within the company's line of business and is of practical advantage to it; and (3) by taking advantage of the opportunity, the officer or director will be placed in conflict with the interests of his or her corporation. State law usually sets forth a process by which the individual officer or director can faithfully pursue the opportunity with company approval.

In this case, the Chancery Court ruled that a company's co-founder and former CEO owed approximately \$2.7 million and was properly terminated after he usurped a corporate opportunity by secretly purchasing—and then attempting to lease back to the company—particular property that the company had been considering for years as part of a planned expansion in the region. The chancellor did, however, clear the former CEO of charges of disloyalty linked to three employees' sexual harassment allegations against him. Facts indicating that the CEO secretly negotiated with the property ownership to purchase the property (despite knowing that his company was interested in the property and could afford to purchase it) were sufficient to demonstrate a breach of the duty of loyalty.

Usurpation issues can be expected to increase as health care companies expand their portfolios into various new areas of operation, service lines and other investments. The general counsel may wish to prepare guidelines on corporate opportunity for the education of officers, directors and health care personnel.

ADVAMED'S NEW CODE OF ETHICS

The newly revised **Code of Ethics of the Advanced Medical Technology Association** (AdvaMed) is worthy of notice by all ethics and compliance officers of health care organizations, not only those involved in medical technology.

The new AdvaMed Code contains a series of revisions to the 2009 version of the Code and will not be effective until January 1, 2020. The revised Code incorporates several

important ethical themes that are likely to be of broad interest. These include:

- An expanded description of “cornerstone values” against which medical technology companies should review all interactions with health care personnel
- The recommendation that such companies adopt the AdvaMed Code and implement an effective compliance program
- Expanded and clarified guidelines with respect to company-conducted training and education and sales/promotion meetings, as well as for educational and research grants, charitable donations and commercial sponsorships
- Parameters for when it is permissible to make payment for travel and lodging costs of health care personnel attending company programs
- Guidelines for co-conducted education and marketing programs

The revised AdvaMed Code also scrutinizes consulting arrangements with physicians, with particular focus on the demonstration of “legitimate need” for the services, reasonableness of terms, conflicts mitigation, the limited role of company sales officials and the need to confirm the delivery of services as described under the agreement.

In these and other ways, the revised AdvaMed Code of Ethics is a useful reference point for legal and compliance officers charged with the continuing effectiveness of corporate ethics and compliance guidelines.

THE BOARD, THE “BULLY BOSS” AND WORKFORCE CULTURE

Recent media coverage of the so-called “horrible boss” circumstance offers a **board teaching moment** with implications for workforce culture oversight obligations.

This is a place where many conflict-sensitive boards have historically avoided, not wanting to “poke the bear.” Yet it goes to the heart of key fiduciary oversight obligations for oversight of executive performance, workforce culture and talent development. Coverage of “bully bosses” in *The Wall Street Journal* and *The New York Times* has served to call out abusive executive behavior, while raising serious

challenges for corporate governance on how best to address the problematic conduct of ANY CEO, regardless of gender.

Such abusive behavior acts should violate any company's code conduct, which would automatically invite board review. Yet such a review would be inherently *reactive* in nature, occurring after the problematic conduct (and resulting damage) has occurred. Indeed, the intense public reaction to these media stories underscore the inherent weakness of a reactive board strategy.

That's why a more *pro-active* board strategy may be called for. Such a strategy could be grounded in increased executive awareness of personal conduct expectations, combined with targeted executive training and education. A pro-active strategy would also incorporate a more explicit reporting and whistleblower system with straight line reporting to the board, and would also be aligned with three specific and highly relevant fiduciary oversight duties (culture, talent development and CEO monitoring).

NEW GUIDANCE FOR THE CEO SUCCESSION COMMITTEE

Stanford University Professor David Larcker offers valuable new analysis to the board committee responsible for CEO search and succession.

In two separate new commentaries, Prof. Larcker addresses both the practice of allowing the CEO to select his or her successor, and the efficacy of the interim CEO appointment.

Writing in *The Wall Street Journal*, Prof. Larcker argues against allowing the CEO to have a significant role in the selection of his or her successor. He cites the CEO's lack of experience in this activity, the fact that the CEO is unlikely to have the right perspective to evaluate successors, and the potential for the CEO's behavior to distort the process. He observes that CEOs too often have a bias for preserving their legacy, as opposed to working to assure the right direction for the company's future. While the CEO may play a valuable role, the board "should own the succession process."

In a separate publication, Prof. Larcker concludes that several factors can make the board's selection of an interim CEO more prone to failure:

- The interim CEO is appointed by a board with shorter tenure.
- The board is less "connected," *i.e.*, the directors who appoint the interim CEO hold fewer outside board seats.
- CEO duality implies lower likelihood of interim appointment upon departure.

The selection of a CEO (interim or full time) is one of the board's primary fiduciary responsibilities and should be executed with diligence. Prof. Larcker emphasizes the importance attributed to a succession committee composed of directors with experience in succession management and led by a credible, qualified director. The participating committee members should have a clear awareness of four key factors identified by Prof. Larcker as critical to a successful process: familiarity with the company's strategy, awareness of the criteria needed to succeed in the coming environment, an understanding of the executive labor pool—both internal and external—and a detailed process for vetting the candidate pool to candidates who are most likely to succeed.

BOARD RESPONSE TO CLO DEPARTURE

The recent departures of several high-profile CLOs highlight the board's obligations to exercise close scrutiny of the rationale and circumstances for those departures.

One of the departures involved a person who had served a prominent automotive technology company as CLO for only two months before returning to his former law firm. Another circumstance involved the departure of the CLO of an entertainment company following a long and highly publicized controversy involving the company, its board and its former CEO.

The departure of a company's general counsel should almost always raise the yellow flag in the boardroom, no matter the circumstances. Director alertness should be enhanced, and a diligent inquiry into the circumstances should be conducted. The general counsel is no ordinary officer, and his or her departure is no ordinary event.

The board has a fiduciary obligation to exercise oversight for the office of the general counsel, including matters of hiring, compensation and termination. The essence of the

obligation is to ensure that the company attributes appropriately high value to matters of legal compliance. This position should never be marginalized by hiring underqualified persons, placing them at significantly subordinated hierarchical levels, or compensating them far below the industry average.

The obligation also extends to being notified of—and fully advised of the reasons for—the termination or departure of the general counsel. The board must understand why the general counsel has left, and may need to hear that directly from the general counsel on that count. It is always possible that through such an exit interview or other discussion, the board may be alerted to consequential facts or circumstances of which it would not otherwise have been aware.

REMEMBERING ENRON

The **release of the last incarcerated former Enron official** is a useful reminder of the vitally important nexus between that seminal corporate scandal and the current corporate responsibility principles that guide board conduct.

In mid-February 2019, Jeffrey Skilling, former Enron CEO, was released from prison upon completion of his sentence following conviction on 12 counts of securities fraud, five counts of making false statements to auditors, one count of insider trading, and one count of conspiracy for hiding debt and orchestrating the fraud that resulted in Enron's bankruptcy.

While Mr. Skilling has now paid his debt to society, his release provides an excellent opportunity for the general counsel to review with a new generation of corporate officers and directors the problematic board conduct that proved to have seismic and lasting implications for corporate governance. The continuing relevance of Enron is at least two-fold:

- First, it provides jaw-dropping examples of problematic governance conduct from which no board, at any time, is safely immune.
- Second, it provides a clear explanation for the corporate accountability environment along with the enactment of Sarbanes-Oxley.

In essence, Enron is the “root” of the modern corporate governance “tree.” The emphasis on director independence, governance principles, “best practices,” codes of corporate ethics, financial transparency, whistleblower access, informed decision-making, enhanced board oversight, conflicts and compensation sensitivity, and “constructive skepticism” can be directly traced to the perceived and admitted failures of the Enron board.

Subsequent amendments to the compliance program effectiveness standards of the influential Federal Sentencing Guidelines, dealing with governance responsibilities, also reflect a clear Enron/Sarbanes theme. These are all worthwhile lessons for today's board members and senior executives, many of whom were not serving in executive or fiduciary positions more than 18 years ago.

Finally, the Enron circumstances should serve as a reminder that “the smartest guys in the room” have a nasty habit of popping up again, and again, in executive suites across industry sectors, year after year. Strong and effective board oversight provides the necessary checks and balances to spirited, aggressive management, especially in those situations when the “edge of the envelope” begins to appear.

GRASSLEY'S AGGRESSIVE OVERSIGHT

Only several months into his chairmanship, Senator Charles Grassley has already directed the Finance Committee on two separate investigative initiatives relating to the tax-exempt sector, including hospitals.

The senator's first initiative was a request that the US Olympic Committee (USOC) (a Section 501(c)(3) nonprofit organization) outline specific actions it has taken to support athletes affected by the Dr. Larry Nassar sexual assault scandal and to prevent future abuse of athletes.

Sen. Grassley's primary focus is on whether USOC governance is exercising sufficient programmatic oversight; the concern being that it fostered a culture that prioritized Olympic medals and revenue over the safety and well-being of its athletes. He stated that the committee's interest in USOC governance is related to its authority to ensure proper compliance by tax-exempt entities with the scope of their charitable purposes—pointing in this case to the congressionally expanded purpose of the USOC to require a

“safe environment in sports that is free from abuse, including emotional, physical and sexual abuse, of any athlete.” USOC provided a lengthy reply to the inquiry, detailing a series of activities and reforms it has initiated.

Senator Grassley’s focus on compliance with charitable purposes is consistent with the Pennsylvania Attorney General’s petition also discussed in this newsletter, and with other recent state attorney general investigations of “mission drift.”

The second investigative initiative was the senator’s lengthy February 19, 2019, letter to Internal Revenue Service (IRS) Commissioner Rettig, requesting information on the status of IRS review of tax-exempt hospital compliance with the provisions of IRC Sec. 501(r) (added by the Affordable Care Act to include new additional 501(c)(3) requirements for hospital facilities). The letter contained seven separate detailed questions intended to determine the status, extent and scope of IRS enforcement of this code section. These included questions on the number of reviews and examinations of tax-exempt hospitals undertaken by the IRS in the last 10 months and the extent of noncompliance with 501(r) uncovered. Other questions related to the number of hospitals that failed to satisfactorily publicize their financial assistance policies, engaged in extraordinary collection actions, or failed to make reasonable efforts to determine whether their patients qualified for financial assistance. The letter also contained a reference to the enforcement action taken against Mosaic Life Care when Senator Grassley headed the Judiciary Committee.

These two inquiries provide a clear indication that Senator Grassley will, as expected, be an aggressive regulator of the tax-exempt sector, as he has been in the past.

CODE OF CONDUCT CONCERNS

Recent incidents involving personal conduct allegations against two leading sports executives provide a code of conduct teaching moment.

The first incident involved allegations that the owner of a championship professional sports team solicited a prostitute at a massage parlor and salon. The arrest occurred in the context of a larger police investigation into human trafficking in the state. The sports team owner, who has

denied the allegations, has been charged with two misdemeanor counts of soliciting a prostitute.

The second incident involved the president and chief executive officer of a professional sports team being captured on video in a physical altercation with his wife in a public plaza that ended with her on the ground. No charges have been filed as of this date, and the executive will take a leave of absence from the team. The relevant league offices are reviewing the respective incidents. Each league has detailed codes governing the personal conduct of owners, executives and players. At least one of the leagues has a specific policy governing the allegations in question (domestic violence).

How the leagues handle these respective incidents—sensitive allegations against high-profile individuals—will be instructive to health care company boards that must confront similar personal conduct allegations involving officers and directors. This is particularly the case with allegations of code of conduct violations that are simultaneously the subject of judicial proceedings or separate employer/separate board review.

Note too that “fitness to serve” policies, which require resignation upon the occurrence of certain events involving an officer or director, can be a more direct (if not also harsh and uncompromising) way of reducing the reputational impact of an embarrassing incident involving an officer or director.

THE BOARD AND GENDER EQUALITY

The recent International Women’s Day (March 8) provides a good opportunity for the board to re-evaluate its oversight of, and commitment to, gender equality.

The #MeToo movement has evolved into a serious discussion of the need to advance women and improve gender diversity within the organization. This issue vaulted to the forefront of boardroom discourse with **the fall 2018 McKinsey report** on women in the workplace and related developments.

The McKinsey report makes clear that gender parity and issues involving sexual discrimination and harassment are completely intertwined. Boards must be prepared to address internal issues associated with the promotion of women. The report, prepared with support from LeanIn.org, calls for

decisive action by companies to address the promotion of women across all levels of the organizational hierarchy. It is a report that should be brought to the board's attention.

The fundamental message to corporate boards is that an approach that only responds to #MeToo concerns is insufficient to the extent that it fails to pay attention to the gender gap. The McKinsey/LeanIn.org report identifies the dramatic power imbalance in the workplace that needs to be resolved—an imbalance that is, fundamentally, the board's job to fix, because it requires a tone set at the top and is part of the board's broader fiduciary obligation to exercise oversight of workforce culture issues. It also implicates the board's oversight of talent development and the benefits of attracting and retaining a diverse workforce.

None of this constitutes an excuse for boards to back off on their commitment to fairly and fully addressing allegations of harassment in the workforce. Nor should the board's commitment be affected by reports that a gender wage equality survey conducted by an iconic US technology company showed that, for certain positions, men were actually being paid less than women for similar duties. That survey did, however, serve to focus more attention on the human resources concept called "leveling," and how it (together with performance ratings and promotion) affects pay.

Boards should use International Women's Day as a prompt to confirm the extent to which the organization has adopted a comprehensive approach to gender equity matters. The general counsel, perhaps teaming with senior human resources executives, is well suited to lead this effort.

FOR MORE INFORMATION

For additional information, please contact Michael Peregrine at +1 312 984 6933 or mperegrine@mwe.com or visit mwe.com/governinghealth.

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