

Business Judgment and the Health System Board

First in a Series of Commentaries Addressing Key Fiduciary Concerns

By Michael W. Peregrine, McDermott Will & Emery LLP, Chicago, IL

An increasingly critical role of the health system general counsel is to support the ability of board decision making to qualify for business judgment rule (Rule) protection. This is no small task, particularly in the context of the nonprofit corporation.¹

The post-Affordable Care Act wave of merger activity is recasting the nonprofit hospital sector away from a community-based focus towards large regional, multi-state and national health systems. These are highly sophisticated enterprises with very diverse operational portfolios and huge annual revenues. Their boards are confronting agendas of previously unanticipated complexity. The competencies required of the board are changing and the level of engagement expected from the board is increasing. The board's approach to decision making must itself become more sophisticated to better assure the sustainability of those decisions.

The basic principle of the Rule²—that businesspeople are generally more competent than courts to exercise business judgment—has historically been the backbone of the “decision-making element” of the board's duty of care. The voluntary board has relied on the Rule as a means for both reducing its liability profile and for attracting otherwise qualified director candidates. As the dimensions of health system board service increase dramatically, the availability of the Rule's protection takes on added significance. Yet, in the context of the nonprofit health system, *the availability of the Rule cannot be assumed*. The efforts necessary to assure that protection are similarly increasing—to a point that may extend beyond many a board's traditional preparation practices. This is particularly made clear by recent case law and regulatory enforcement action.³ For this reason, it is vital that health system leadership allow the general counsel to play a more expansive role in supporting board and committee decision making.

Positioning the general counsel to advocate (and prepare) for a more prominent boardroom role requires familiarity with judicial interpretations of the Rule. It also requires an awareness of those elements of the board's decision-making process that are critical to satisfying the Rule's requirements. It will be aided by sensitivity to particular agenda items (e.g., major transactions, physician integration, executive and physician compensation, financial commitments, and investments) for which heightened board engagement may be expected.

Framework of the Rule

The business judgment rule is a judicial doctrine that insulates directors from liability for errors in judgment exercised

by good faith, without bias or conflict, and with the rational belief that the particular decision is in the best interests of the corporation.⁴ The law does not expect directors to be “guarantors of successful performance.”⁵ In other words, “[M]istakes in the exercise of honest business judgment do not subject directors to liability for *negligence* [emphasis added] in the discharge of their fiduciary duties.”⁶

[W]hether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through “stupid” to “egregious” or “irrational”, provides no ground for director liability, so long as the court determines that the *process employed* was either rational or employed in a good faith effort to advance corporate interests.⁷

The Rule is premised upon the belief that courts are not well-positioned to “second guess” the informed, disinterested, and good faith decisions of a board that has been entrusted with the management of corporate affairs.⁸ The Rule's protection is intended to encourage rational risk-taking and innovation by board members, reduce their liability exposure, support the recruitment of competent director candidates, and limit judicial intrusiveness into corporate affairs.⁹

The Rule incorporates a presumption in favor of its application; i.e., assuming the presence of its core elements, courts generally will not question the board's substantive decisions.¹⁰ A plaintiff seeking to challenge director conduct in connection with a board decision often encounters particular barriers in many jurisdictions, including special pleading requirements that require presentation of factual allegations that question this business judgment rule presumption (e.g., allegations of bad faith).¹¹ Thus, when applicable, the Rule will protect a director's decision concerning business and discretionary matters on which board vote is taken.¹² Note in this regard that the Rule's protection applies to the exercise of judgment; e.g., an actual decision or vote of a director. It does not extend to the exercise of oversight of a director.¹³

Relationship to Negligence

Advising the health system board on the Rule's application requires an understanding of its relationship to the concepts of simple and gross negligence.¹⁴ While the standard of director liability under the business judgment rule is predicated on concepts of gross negligence, its foundation is based upon the *rationality of the board's decision-making process*—which

is subject to a more basic “prudent person” analysis, and concepts of simple negligence.

As a recent decision of the Georgia Supreme Court makes clear, the Rule protects directors (and officers) from negligence-based claims relating to the basis of their judgments, but not from negligence-based claims alleging that they acted without the requisite deliberation or diligence, or bad faith.¹⁵

Put another way, the business judgment rule at common law forecloses claims against officers and directors that sound in ordinary negligence when the alleged negligence concerns only the wisdom of their judgment, but it does not absolutely foreclose such claims to the extent that a business decision did not involve judgment because it was made in a way that did not comport with the duty to exercise good faith and ordinary care.¹⁶

This is the critical distinction between claims alleging *uninformed* decisions (e.g., allegations focused on the way in which a decision was made) and those alleging *unreasonable* decisions (e.g., allegations focusing on the merits of the decision). The Rule should apply to protect directors from simple negligence claims based on the latter, but not on the former.¹⁷ Thus, directors may be exposed to claims alleging simple negligence in connection with the process by which a decision was reached. In such a situation, board conduct will typically be evaluated in the basis of the “ordinarily prudent person” standard; i.e., whether the board conducted a level of inquiry that an “ordinarily prudent person” would have applied given similar facts and circumstances.

The question is frequently asked, how does the operation of the so-called ‘business judgment rule’ tie in with the concept of negligence. There is no conflict between the two. When courts say they will not interfere in matters of business judgment, it is presupposed that judgment—reasonable diligence—has been exercised. A director cannot close his eyes to what is going on about him and have it said that he is exercising business judgment.¹⁸

This is where the general counsel can be of great service—by helping to structure a specific board decision-making protocol that guides the board towards the exercise of “ordinary care” (i.e., diligence, disinterest, intelligence, and judgment) that is called for by the specific facts and circumstances. This a particular challenge because the requisite care will be affected by such circumstances as the financial sophistication of the organization, the complexity and risks associated with the particular decision, and the regulatory implications of the decision.

Indeed, as health systems grow in terms of size, revenues, financial sophistication, and operational diversification, previously assumed concepts of “ordinary care” will likely evolve. What may have been an acceptable system board decision-making process in 2005, or 2010, may well be unac-

ceptable in 2015. Boards that have not changed their decision-making process to reflect organizational growth and agenda complexity may be particularly vulnerable to “ordinary care”-grounded claims. It will be important for executive and board leadership to grasp this concept and to support the initiatives of the general counsel to “upgrade” the process—for the ultimate protection of the board, and of the corporation. This may require some leadership re-orientation.

In enhancing the board’s decision-making process, the general counsel will want to consider judicial decisions identifying substandard care and limitations on the board’s “right of reliance,” and regulatory developments with respect to certain specific actions the board may be called upon to approve.

Procedural “Trip Wires”

The emphasis on “process” that is at the core of the business judgment rule supports the role of the general counsel in advising the board on its approach to decision making. Especially in the context of the application of the Rule, “process” is a highly “legal” concept.

While over 30 years old, the 1985 decision of the Delaware Supreme Court in *Smith v. Van Gorkum* continues to offer general counsel practical examples of board procedural failures; i.e., board conduct so egregious that it constituted gross negligence and jeopardized availability of business judgment rule protection.¹⁹ This class action litigation sought rescission of a merger of Trans Union Corporation (TUC) into another corporation controlled by a merger specialist who was also a social acquaintance of the TUC chairman. The plaintiffs alleged that the TUC board breached its duty by acting in a uniformed manner to approve the merger. The Delaware Supreme Court agreed, concluding that the TUC board approved the merger without fully informing themselves of the consequences of the transaction. The facts contributing to the court’s conclusion provide stark (yet highly relevant) examples of flawed conduct:

- » Approved a merger agreement without any written documentation whatsoever, including any written summaries of the merger terms or any valuation studies.
- » Neither the chief executive officer (CEO) nor the board members read the agreement or amendments before execution.
- » The board failed to make a reasonable inquiry into the relevant facts and circumstances surrounding the rushed proposal.
- » The directors did not adequately inform themselves as to the CEO’s role in forcing the “sale” of the company.
- » The board accepted without scrutiny the CEO’s representation as to the fairness of the share price, and the board was unaware that the CEO suggested the share price to the buyer.
- » The board relied on the CEO’s 20-minute oral presentation of his understanding of the proposed merger agreement, which he had not seen.
- » The directors failed to make a reasonable inquiry of the

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CEO and chief financial officer given the following circumstances: hastily calling the meeting without prior notice of its subject matter, the proposed sale of the company without any prior consideration of the issue or necessity therefor, the urgent time constraints imposed by the buyer, and the total absence of documentation whatsoever.

- » The board did not consider recessing the meeting to elicit more information as to the sufficiency of the offer.

This fiduciary horror story provides practical lessons on positioning the board for informed decision making that extend far beyond the merger context. Thus, in advising on matters of process, the general counsel will want to emphasize such basic matters as:

- » The scheduling of meetings, to make sure they are called with sufficient advance notice.
- » The quality of meeting minutes, and whether they are distributed sufficiently in advance.
- » The level of detail provided in the “board meeting packet,” including the timing of its delivery, the sufficiency of the information, and its relationship to the agenda; whether the information is provided in a context that board members can understand; and whether the meeting agenda provides a sufficient indication of matters coming before the meeting.
- » Matters of timing; e.g., whether meetings (and individual presentations therein) are structured to provide sufficient time to address issues requiring board action.
- » The ability of the board to ask questions of management and advisors in connection with particular proposals, and receiving copies of written reports, etc., generated by management and by advisors.
- » Assuring that committees and/or the full board have reviewed written materials describing/memorializing the proposal.
- » Providing board members with appropriate feasibility and risk analyses for the proposal, summaries of advantages and disadvantages, and identification of possible options.
- » The conduct of meetings at which a proposal is made (e.g., assuring open discussion of all relevant issues and encouraging open debate and involvement amongst meeting participants).
- » The identification and resolution of all actual and perceived conflicts arising from the proposal.

Limitations on Reliance

The general counsel also will want to focus on the board’s right to rely on the work of committees, and on the advice of management and outside advisors, in connection with its exercise of informed decision making. An overarching concern will be to make sure that the board’s reliance is reasonable in all respects, and able to withstand a regulatory or litigation challenge.

Committees. Many state corporation codes expressly authorize committees to exercise all powers of the board of directors with respect to matters as may be authorized in resolution or committee charter, subject to certain limitations.²⁰ It is not uncommon for boards to delegate to a committee the responsibility for analyzing or developing certain proposals or arriving at recommendations for board action, with the board members relying in part on the diligence of the committee in determining how to vote. Examples include a negotiation committee leading the board’s efforts in a major transaction, the executive compensation committee, the executive search committee, the nominating committee, and the strategic planning committee.

The act of delegation does not, however, satisfy the board’s fiduciary responsibilities with respect to the matter at hand (particularly if the board is required to ratify the committee’s decision). The general counsel will want to work with the board to make sure that the delegation has been appropriately structured, as reflected in such important matters as its composition/level of expertise, lack of conflicts, charter, meeting schedule, funding, access to resources and advisors, and preparation of written reports for, and presentation to, the full board. Attention to these factors can help support the reasonableness of reliance.

Outside Experts. These state laws similarly recognize the benefit of allowing directors to rely in part on the input of external advisors in connection with business judgment.²¹ There are, however, several significant limitations to this general concept.

First is that reliance is not reasonable when the record is clear that the board/committee neither reviewed nor relied upon the advice of the outside expert in making his/her decision on how to vote. Second is where the director(s) knew, or had reason to know, that such reliance was unreasonable under the circumstances. Some of the most often-cited examples of such unreasonable reliance are: (a) where the advisor was not sufficiently qualified to render advice (e.g., a lawyer providing advice outside his/her expertise); (b) the advice provided was not specific to the matter on which reliance was sought; (c) the advice provided was of insufficient quality as to justify reliance under the circumstances; or (d) the advisor had an actual or perceived conflict of interest in connection with the matter. These types of limitations are a primary reason why the general counsel should be involved the advance planning for the selection of any external advisor.


Executive Management. The duty of care similarly recognizes the benefit of allowing directors to rely in part on the input of corporate officers, such as members of the executive leader-

ship team. The management/board interaction is typically a critical portion of the decision-making process. In this regard, the general counsel will need to be attentive to three potential limitations on the right of reliance. The first arises when a particular executive has an actual or perceived conflict of interest in connection with the transaction. This most often arises in transactions where the executive has, or will have upon closing, a financial or employment relationship in or with the other party or organization. Actual or perceived partiality of an executive limits the ability of the board to rely on the executive's advice. A second limitation arises when the board culture reflects over-dependence on the leadership team (i.e., does not pursue issues nor independently present questions or concerns). A related limitation could arise when the board relies exclusively on senior leadership for information and guidance on major transactions, without the input of outside advisors.

Special Circumstances

Obviously, the extent of necessary procedural steps depends upon the facts and circumstances associated with the decisions presented to the board. Decisions that involve significant financial, legal, or regulatory implications will often require a greater degree of procedural steps and board preparation than with more ordinary course transactions. Examples include the approval of complex bond financing and investment matters; the initiation and settlement of material litigation; resolution of regulatory investigations; business affiliations that do not constitute a change of control; selection of specialized outside advisors; senior executive succession; and matters that implicate statutes or regulations, or for which regulatory safe harbors may be available (e.g., executive and physician compensation; physician integration compliance).

Conclusion

The business judgment rule is an extraordinarily supportive governance tool for health care boards. It is not, however, automatically applicable to major board decisions, being dependent upon the presence of a rational process to better assure informed and disinterested decision making. With the dramatic evolution of the health care sector into a smaller number of larger and more complex organizations, the law's expectations for such a process will be increased. The health system general counsel is uniquely well suited to advise the board on satisfying the Rule in general, and on its decision-making process in particular. 

About the Author

Michael W. Peregrine (mperegrine@mwe.com) is a partner in the law firm of McDermott Will & Emery LLP and is based in the firm's Chicago, IL, office. He focuses his practice in the representation of nonprofit corporations in connection with governance, corporate structure, and change-in-control matters. Mr. Peregrine is outside governance counsel to many leading



nonprofit corporations. He has served as special counsel in connection with numerous confidential internal reviews and investigations. He also has substantial experience with complex business transactions, having advised nonprofit clients on over 120 separate mergers, acquisitions, and dispositions. Mr. Peregrine was named an AHLA Fellow in 2006, and is a frequent author and speaker on legal topics affecting tax-exempt, nonprofit corporations.

Endnotes

- 1 Many state courts have recognized the business judgment rule as applicable to nonprofit corporations. See, e.g., *Oberbillig v. West Grand Towers Condominium Ass'n*, 807 N.W.2d 143 (Iowa 2011); *Mueller v. Zimmer*, 124 P.3d 340 (Wyo. 2005); *Janssen v. Best & Flanagan*, 622 N.W.2d 876 (Minn. 2003).
- 2 A notable treatise describes it as "less a rule than an accumulation of case-law statements." The American Law Institute Principles of the Law of Nonprofit Organizations, Tentative Draft No. 1 (Mar. 19, 2007) at Section 365 (henceforth, "ALI Nonprofit Principles").
- 3 See, e.g., *Official Committee of Unsecured Creditors v. Baldwin (In re Lemington Home for the Aged)* 659 F.3d 282 (3d Cir. 2011).
- 4 See generally ALI Principles of Corporate Governance: Analysis and Recommendations (henceforth, "ALI Corporate Principles"), Section 4.01 (c), Comment.
- 5 ALI Nonprofit Principles, *supra* note 2, at Section 365.
- 6 *Casey v. Woodruff*, 49 N.Y.S.2d 625 (N.Y. Sup. 1944, as cited in *Federal Deposit Insurance Corporation v. Loudermilk*, 295 Ga. 579; 761 S.E. 2d 332 (Ga. July 11, 2014) (henceforth, "Loudermilk").
- 7 *In re Citigroup Inc. Shareholder Derivative Litig.*, 964 A.2d 106 (Del. Ch. 2009) (emphasis added); citing *in re Caremark Int'l Inc. Shareholders Derivative Action*, 698 A.2d 959, 1996 Del. Ch. LEXIS 125 (Del. Sept. 25, 1996 (960).
- 8 *Loudermilk*, *supra* note 6.
- 9 Harvey J. Goldschmidt, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems and Proposed Reforms*, 23 J. CORP. L. 631, 639-40 (1998).
- 10 ALI Corporate Principles, *supra* note 4, Section 4.01(a).
- 11 Section 8.30(b) (Comment), Model Nonprofit Corporation Act (Third Edition), Committee on Nonprofit Organizations, Section of Business Law, American Bar Association (2008) (henceforth, "Model Act").
- 12 Model Act, *supra* note 11, Section 8.31, *Note on the Business Judgment Rule*.
- 13 This is a topic to be addressed in the second installment of this *Connections* series.
- 14 Generally speaking, "simple negligence" refers to the failure to use the degree of care of an ordinarily prudent person under similar circumstances; while "gross negligence" refers to reckless indifference to the corporation's interests.
- 15 *Loudermilk*, *supra* note 6.
- 16 *Id.*, at 585, 586.
- 17 *Id.* Note, of course, that allegations that decisions were made "without deliberation" or in bad faith" are not grounded in simple negligence, but rather on allegations involving reckless indifference or failing to act in the presence of a known duty to act.
- 18 *Casey v. Woodruff*, *supra* note 6, at 643-644. "The business judgment rule does not insulate "mere dummies or figureheads" from liability . . ."; *Loudermilk*, *supra* note 6.
- 19 488 A.2d 858 (Del 1985).
- 20 See, e.g., Section 8.25, Model Nonprofit Corporation Act Third Edition, Committee on Nonprofit Organizations, Section of Business Law, American Bar Association (2008); 8 Del.Ch. § 141(e).
- 21 *Id.*; ALI Principles of Corporate Governance: Analysis and Recommendations Section 4.02.

Mentee Misperceptions and Practical Advice

By Tracy Carlson Ivers,
Masonicare, Wallingford, CT

I have always admired the mentor-mentee relationship. Great mentors create great leaders. Everyone knows this. Remember Luke Skywalker? He not only had one, but two remarkable mentors: Obi-Wan Kenobi and Yoda. Harry Potter had Professor Dumbledore leading him through the world of wizardry. And, who could forget little Daniel Larusso? Who knows what would have become of Daniel without his karate master, Mr. Miyagi, to lead the way? Wax on, Wax off! Hollywood has played a key role in how we perceive the mentor-mentee relationship. Early on, thanks to the big screen, we learned that when we are paired with just the right mentor, triumph is certain!

I have often envisioned my future mentor. He would intuitively know my path and reveal it to me once he'd sufficiently prepared me for greatness! He would try to break my spirit, and then inspire me with phrases like, "With great power comes great responsibility."¹ He would call me "grasshopper" and teach me to snatch the pebble from his hand.² My mentor would create a

rigorous training routine that I would unwittingly follow. I would only have to show up, work hard, and not question his methods in order to succeed.

Suffice it to say, we all know that Hollywood takes enormous liberties when it comes to depicting reality. The mentor-mentee relationship is no different. Mr. Miyagi, Dumbledore, and Yoda are fictitious characters, much like Santa and the Easter Bunny. If you plan to be a successful mentee, you are going to have to do much more than pray for a Christmas (or Hanukkah) miracle! You must be optimistic and enthusiastic. You must be willing to take initiative, work smart, be charming (not offensive), set goals, embrace new projects, be a team player, establish goals, and demonstrate value, all while maintaining open and honest communication with your mentor.

In truth, mentors and mentees must participate equally in the relationship if it is to be a successful and rewarding experience for both parties. A study conducted by Dr. Sharon Straus, a researcher at St. Michael's Hospital and author of "What Makes a Good Mentor and Mentee?" identified five key elements to what makes a mentoring relationship successful. They are: reciprocity, mutual respect, clear expectations, personal

connections, and shared values.³ Having had my AHLA mentor for nearly five years now, I could not agree with Dr. Straus' findings more.

I consider my mentor-mentee relationship to be one of the best. I met my mentor (let's just call him "Michael") before AHLA had officially established its Mentoring Program, at an AHLA networking event. I followed up with Michael, post-conference, with the "nice to meet you..." email, and so the mentorship began. Over the years, Michael has encouraged me to call him with questions, write articles, attend conferences with him, and speak at events. He has introduced me to his colleagues and friends, who have since become valued colleagues and friends of mine as well. I am eternally grateful for this.


Had I realized that cultivating a healthy mentor-mentee bond rests, to a large extent, in the hands of the mentee,⁴ perhaps I could have brought greater value to my mentor, earlier on in the process. He was, luckily, not discouraged by my ignorance. When AHLA finally established its official Mentoring Program, Michael and I signed up and "formalized" our relationship. I'm here to share some of the valuable mentee lessons I've learned over the years, and hope to shed some light on how you can create your own successful mentor-mentee relationship.

The cornerstone of any successful mentor-mentee relationship lies squarely on having mutual respect, responsiveness, and accountability. Time is precious. As a mentee, make it your business to maximize the time you spend with your mentor. Be on time, be prepared, follow through with goals you have established together, be responsive to feedback, and know how to bring value to your mentor. Understand what motivates your mentor and perhaps try and emulate that motivation in your own career, if you find that it fits your



personality. If you are unsure as to the motivations of your mentor, ask him or her to share them with you. Periodically schedule time to evaluate progress, set new goals, and discuss possible frustrations, roadblocks, and solutions.

With my mentor by my side, I have accomplished a number of my professional goals. To name just a few, I have written articles, sat on panel discussions, written regulatory “alerts,” conducted interviews, served on the Board of Directors of a local hospital, and am a member of AHLA’s Women’s Leadership Council. I can only thank him for his guidance, energy, and motivation and hope that he finds his role as my mentor equally as rewarding. My mentor consistently challenges me in surprising ways, and with each challenge I learn something new about myself and my abilities. With AHLA’s Mentoring Program now firmly in place, mentors and mentees will have a better opportu-

nity to capitalize on their relationships much earlier on in the process. Despite my shaky start, Michael continues to give me the encouragement and brutal honesty I sometimes need to make progress. He challenges me and pushes me to work outside of my comfort zone. He simplifies projects that I unnecessarily, but inevitably, overthink and overcomplicate. He is my most trusted and loyal advisor. He is my Mr. Miyagi. 

About the Author



Tracy Carlson Ivers
(tivers@masonicare.org)
is Attorney–Legal and Compliance Analyst at Masonicare in Wallingford, CT, and a skilled

attorney with more than 15 years of experience in various areas of health care law, regulatory compliance, and

civil and criminal litigation. She has conducted criminal and negligence case management, discovery, depositions, settlements, and trials. Ms. Ivers has provided legal and compliance services in both the managed care and hospital settings. She has negotiated reimbursement due to fraud, waste, and abuse on behalf of managed care organizations, and has assisted health care providers to defend overpayment claims. In addition to being an accomplished attorney, Ms. Ivers also is a Certified Professional Coder and is certified in Healthcare Compliance. She is also a member of the AHLA Women’s Leadership Council.

Endnotes

- 1 Spiderman.
- 2 Kung Fu.
- 3 St. Michael’s Hospital, “What makes a good mentor and mentee?” *ScienceDaily*, 30 November 2012.
- 4 How to Be a Good Mentee; Association for Psychological Science, by Tess MS Neal.

AHLA Mentoring Program



Folks give their time and talent to help anyone who is interested to learn.

—David Cade

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