

*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:*

## 1. DIRECTOR LIABILITY

Two perspectives on director liability, emerging from the for-profit sector, may have application to boards of nonprofit health systems. **One perspective** is that bylaw-based exculpatory protection for directors, as provided for under state law, may have significant limitations. According to this perspective, conscientious directors who follow a process (e.g., change of control) on the advice of experts, that is subsequently determined to fall outside the range of reasonableness, may be found to have breached the applicable standard of conduct despite being fully protected from monetary penalties by the exculpatory provision. The **other perspective** is that the power of certain regulators to bar officers and directors from future board service is an underutilized enforcement device which should be applied more often to correct director oversight failures. Note that this power was used by the New York Attorney General in a **prominent 2012 settlement** involving a nonprofit organization.

## 2. ROLE OF THE GENERAL COUNSEL

**Two new surveys** lend empirical support to the view that the general counsel of a sophisticated enterprise (such as a health system) has highly consequential responsibilities, and thus should occupy a position of hierarchical importance within the organization. These surveys reflect an evolving role for the general counsel, by which he/she is increasingly viewed as a leading and valued member of the executive team. The general counsel's responsibilities are perceived as extending beyond traditional legal tasks to include governance and risk management, and providing material contributions towards the development of business strategy. These survey results are particularly significant given new concerns that the governing board is increasingly confused by the lack of clear distinction between the roles of the general counsel, and other key corporate leaders such as the compliance officer, internal auditor, chief risk officer and privacy officer.

## 3. UNENFORCEABLE COMPENSATION

An important **new decision** from the Second Circuit U.S. Court of Appeals provides guidance to general counsel and to compensation committees on the use of the "unenforceability defense" to avoid payment on contracts involving allegedly excess executive compensation. The appeal arose from the employer (a nonprofit health insurance plan)'s breach of an agreement to pay its former CEO certain incentive compensation amounts. The state insurance commissioner had determined that a portion of the compensation was excessive as a matter of law, and that the compensation program was flawed (because, for example, it paid out at or above the target level more frequently than would be expected). The former CEO filed suit seeking damages arising from the breach. The Court of Appeals affirmed a lower court decision granting summary judgment in favor of the nonprofit, but on different grounds. While the lower court relied on the doctrine of impracticability; the Court of Appeals' determined that the agreement requiring payment of what the commissioner had concluded to be excessive was unenforceable because it was in violation of state public policy considerations.

## 4. TERM LIMITS

The advantages and disadvantages of term limits are discussed in an **influential new scholarly article**, concluding that overarching guidelines or best practices on director tenure restrictions (e.g., term limits) should be avoided. The article acknowledges the general validity of arguments in favor of and opposed to the concept. Yet, it recommends that tenure restrictions be considered on a case-by case basis, and that companies have the option to determine director tenure matters in the context of the board's determination of the governance needs of the organization. In that regard, the article encourages boards to resist pressure from external sources to establish devices such as term limits, mandatory retirement age and similar mechanisms that could conceivably restrict board discretion in making its own decisions on director effectiveness and performance. In essence, the suggestion is that matters of director tenure should be left to the business judgment of the board, rather than being prompted by perceptions of "best practice" or industry norms.

## 5. COMPLIANCE GUIDELINES

Recent **public comments and enforcement actions** from the SEC underscore the importance attributed to a clear allocation of, and coordination with respect to, compliance management responsibilities between an organization's general counsel and its chief compliance officer. The catalyst was a recent enforcement action initiated by the SEC against the compliance officer of a financial services company. The allegations were that the compliance officer was aware of regulatory violations by the company but did not take steps to bring the company into compliance and, instead, affirmatively assisted the violations. In conjunction with this enforcement action, SEC officials have acknowledged the need to remove any confusion as to the expectations for appropriate conduct by compliance officers. While these developments did not arise from the health care sector, and the SEC has no direct jurisdiction over nonprofit health systems, the SEC's interest in providing clear guidelines on gatekeeper conduct is worthy of notice by health system leadership.

## 6. OUTSIDE BUSINESS ACTIVITIES

A sensitive, but increasingly important, oversight responsibility of governance is to provide guidelines on outside business activities and compensation arrangements of the CEO and other senior executives. This oversight is typically based upon terms in the executive employment agreement, or through specific policies adopted by the board and applicable to the management team. The goal is to assure the full-time attention of executive leadership to their responsibilities and to avoid excess compensation, conflict of interest and related concerns with executives who are distracted by other activities or relationships. The value of such oversight was recently demonstrated by **media reports** of an agreement between a state university and its former medical school president by which the university may recoup from the former president income he received from an outside contractor to the university, without the university's permission.

## 7. INTRA SYSTEM DISPUTE

**Recently filed litigation** provides general counsel with a practical example of how significant contractual disputes over financial commitments can arise between corporate members of the same health care system. At the core of the dispute is the proper interpretation of an affiliation agreement pledge by one system member (a nonprofit charitable pediatric support organization) to make donations to the system parent, in support of a related children's hospital. The nonprofit's allegations are that the parent breached its affiliation agreement duties and improperly enriched itself by misapplying the donations, which allegations the parent company denies. The litigation reflects the increasing risk of tension and misunderstanding in parent-subsidiary relationships, created by affiliation, that can threaten the cohesiveness of a health system.

## 8. RISK MANAGEMENT OVERSIGHT

The board's responsibility for oversight of organizational risk management is an increasingly crucial governance task. To that end, it is relevant to note the recent action of the GM board to engage outside counsel in connection with the ongoing ignition-switch controversy. According to **media reports**, the GM board requested its own probe—apart from that which was conducted by counsel to the company—to review how information concerning the alleged product defects was transmitted to the board. Another goal of the board's probe is to ensure that future safety issues are more rapidly brought to the board's attention. In this regard, the efforts of the GM board are consistent with governance-prompted efforts, across industry lines (including health care), to assure that critical risk information (e.g., "information that keeps management awake at night") is transmitted to the governing board in a timely manner and in a context that is readily understandable by the board.

## 9. INDEMNIFICATION & INSURANCE

A **new, thoughtful scholarly article** examines the important question of whether indemnification and D&O insurance truly provide meaningful protection to the board and to executive leadership. Particular focus is placed on state law advancement and indemnification provisions; bylaw provisions that require the organization to advance fees and provide indemnification to the maximum extent permitted by law; typical limitations to indemnification provisions; and scope of coverage/limitation issues under "D&O" insurance policies. The subject of insurance and indemnification protection is highly relevant given the current regulatory emphasis on individual accountability for corporate malfeasance. Greater awareness of the available protections, and potential coverage gaps/limitations, will support informed decision-making by corporate leadership and may prompt efforts to refine the scope and content of such protections. It is, thus, a topic that merits close consideration by the governing board, and corporate officers, in the context of the risk environment in which the health care system operates. The general counsel is well-positioned to lead such a discussion.

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