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### Physician Alignment Proposals: Board Evaluation Guidelines



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**P**ositioning boards to exercise informed evaluation of physician alignment proposals represents an increasingly important health system governance challenge. The strategic importance of alignment strategies, the complexity of particular arrangements, and dramatically increased anti-fraud enforcement activity combine to place new pressures on the board's risk management responsibilities. The proper exercise of these responsibilities may encourage a more focused board oversight template than has traditionally been the case.

This template could be designed to support greater governance scrutiny of alignment strategies in general, and individual proposals in particular. It could also sup-

port more informed decisions concerning an acceptable risk profile for the system. It might also include greater clarity on the alignment matters required to be presented to the board for approval, and on the development of such proposals by management. The health system general counsel is well suited to advise the board, its key committees, and senior management in responding to this important challenge.

Most health system boards have historically approached the evaluation of physician arrangements with good faith. Yet the circumstances surrounding the evaluation process may be changing, and dramatically so. Hospital/physician alignment has become a crucial means of achieving the cost containment and quality of care assurances required by the Affordable Care Act. The competition among health systems to recruit and retain well-managed, productive, high quality physician groups is substantial. The pressures on the management team—including the general counsel—to successfully negotiate and “close” individual transactions is significant.

All this is occurring while increased whistleblower activity, enforcement action<sup>1</sup> and judicial decisions such as *Drakeford v. Toumey*<sup>2</sup> materially increase the organizational risks associated with arrangements that may be perceived as “aggressive.” Thus, the emerging challenge is to assure that board review practices provide the necessary checks-and-balances to management's well intentioned proposals.

Some health systems may already be well situated to meet this challenge. For other systems, it may require a

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<sup>1</sup> “Health-Care Cases Bring in Largest Share of DOJ Fraud Recoveries in Fiscal 2013,” *BNA's Health Care Fraud Report* (18 HFRA 12, 1/8/14).

<sup>2</sup> *United States ex rel. Drakeford v. Toumey*, C/A No. 3:05-288-MBS, 2013 WL 5503695 (D.S.C. Oct. 2, 2013).

re-evaluation of how the board approaches physician alignment oversight. In advising the board on the elements of such a re-orientation, counsel may focus on such critical topics as the applicable standard of care; the orientation of the board in analyzing individual transactions; the proper amount of diligence to be exercised in analyzing individual transactions; the ability to rely on the advice of experts/counsel; and the risks associated with particular transactions.

### The Standard of Care

The basic premise of a reoriented oversight template is the potential for the board to be held to a higher standard of care when reviewing physician alignment arrangements. Most state nonprofit laws require courts to evaluate the fiduciary duties of corporate directors in part through the lens of the particular facts and circumstances presented to the directors when exercising oversight or rendering a decision.<sup>3</sup>

Given the evolutionary changes referenced above, some regulators and interested third parties may assert that the circumstances associated with hospital-physician alignment arrangements have dramatically changed: that they reflect more competitive significance, incorporate greater complexity, and involve more significant enforcement risks than ever before. In other words, as the stakes increase, the applicable standard of fiduciary care likewise must increase.<sup>4</sup>

Certainly, the business judgment rule will be recognized in many states as offering protection to board actions that reflect disinterested decisions based on diligent inquiry.<sup>5</sup> Courts will require a high burden of proof (e.g., gross negligence) to overcome the presumption that the rule applied to individual decisions.<sup>6</sup> Yet, evidence of more meaningful circumstances may, in unique fact patterns, affect the level of basic diligence necessary to sustain the protection of the rule.

For these reasons, there may be significant prophylactic value in revisiting the process by which the board evaluates physician alignment proposals.

### The Board's Orientation

Such a process review may begin by examining the need to reorient the traditional board/management relationship as it relates to the review of physician alignment arrangements. Loyal board members are understandably deferential to senior executives in whom they have trust. They are dutifully reluctant to insert themselves directly into management decisions.

They also are respectful of the tactical and strategic recommendations of management and outside advisors. Yet this relationship may need to slightly pivot with respect to physician alignment arrangements. In those circumstances, a more explicit demonstration of constructive scrutiny by the board of management's pro-

posals could be called for, given the associated complexities and risks.

### Need for Greater Diligence

The board may consider whether a greater amount of diligence on its part is necessary to assure an appropriate level of oversight of alignment-based management strategies and proposals.

In this regard, a useful "measuring stick" is the level of board/committee attention, and more precisely whether the board or a designated committee (the "governance review body") can and will be expected to commit greater time, energy and attentiveness to physician alignment matters than to many other matters on the agenda. This is consistent with emerging perspectives suggesting that certain critical governance functions (e.g., strategic planning, audit and risk/compliance) may require a greater level of fiduciary focus.<sup>7</sup> Given the importance of the issues involved in physician alignment arrangements, boards may wish to consider placing physician arrangements in the same category of critical governance functions requiring greater oversight.<sup>8</sup>

As to *Enforcement Risks*. The governance review body's evaluation efforts will be assisted by periodic education from the management team and outside advisors. This education could relate to the factors that are prompting the current increase in physician alignment arrangements, different options for structuring compliant arrangements, and the legal standards applicable to such arrangements. This **does not mean** that the governance review body must replicate the knowledge of counsel on these matters. It **does suggest**, however, that the evaluation process may be aided by an understanding of both general industry developments and of the relevant enforcement climate. This would include the implications, to both the organization and to individuals, of an enforcement action.

This is particularly the case with respect to the potential for government enforcement actions prompted by a "whistleblower" complaint. Is there a profile of a typical whistleblower? Is the whistleblower motivated just by the prospect of a financial reward? What is the timeline of a typical whistleblower complaint? To what extent does the filing of such a complaint disrupt the work of the organization and the board members? What factors does the government take into consideration in deciding whether to intervene in the whistleblower action? What are the implications to the organization and to individual officers and directors if the government does decide to intervene?

These questions—and the possible answers—would be the basis of a useful dialogue between counsel and the governance review body.

The board should understand that a typical government investigation of a complex health care compliance issue, such as the legality of physician compensation arrangements under the Stark law and anti-kickback statute, can take years to reach resolution. As illustrated on

<sup>3</sup> See, e.g., Section 8.30, "Standards of Conduct for Directors", Model Nonprofit Corporation Act, Third Edition, Committee on Nonprofit Organizations, Section of Business Law, American Bar Association ("Model Act").

<sup>4</sup> Id., Official Comment 2, Section 8.30(b); see also, Michael W. Peregrine, *Healthcare Governance Amidst Systemic Industry Change: What the Law Expects*, The Governance Institute, Winter 2014.

<sup>5</sup> Model Act Section 8.31, "Note on Business Judgment Rule".

<sup>6</sup> Id.

<sup>7</sup> See, e.g., Matthew Tonello, The Conference Board, "Should Your Board Have a Separate Risk Committee?"; Harvard Law School Blog on Corporate Governance and Financial Regulation, February 2, 2012;

<https://blogs.law.harvard.edu/corpgov/2012/02/12/should-your-board-have-a-separate-risk-committee/>.

<sup>8</sup> See, e.g., Peregrine, supra, at p. 10-11.

the timeline at the end of the article, an investigation ordinarily begins with the issuance of subpoenas or civil investigative demands by the Health and Human Services Office of Inspector General.

The initial subpoenas could be issued on the government's own initiative, or triggered by a whistleblower complaint, which is required to be filed under seal. The active investigation period that follows can take several years to complete, during which the whistleblower complaint remains under seal and unavailable to the defendant organization and its lawyers.

During this stage, the organization is producing documents and electronic data, imposing burdensome document and data preservation protocols throughout the organization, and responding to other investigative requests from the government. Government investigators may also seek to interview employees, executives, and even board members of the organization. The organization will typically provide independent legal counsel for each person interviewed.

Once the pre-litigation investigation is complete, the government then decides whether to take enforcement action or intervene in the whistleblower lawsuit. The whistleblower lawsuit is then unsealed, usually garnering some degree of press coverage. In the event the government proceeds with the enforcement action/whistleblower suit, several more years of active litigation will follow, involving additional discovery burden, depositions of employees, executives, and board members, and significant legal, expert, and consulting fees.

It would not be uncommon for the entire process to take more than five years to reach resolution. On top of that, if the organization decides to settle the case, or takes it to trial and loses, the organization could face the imposition of a Corporate Integrity Agreement by HHS-OIG for a term of three to five years.

Aside from the often severe financial consequences of government enforcement actions and whistleblower suits in the health care field, these practical implications are directly associated with the real legal risk that should be considered by the board in the evaluation of physician alignment proposals.

*As to Proposal Development.* The ability of the governance review body to evaluate physician alignment proposals may be enhanced if those proposals are the by-product of a carefully designed, compliance-focused internal development process that is **consistently applied**.

Key elements of such a process might include expectations regarding:

- Business planning/financial projections;
- Types of financial impact that should or should not be considered;
- Mission/service considerations;
- Qualifications of outside advisors to the health system;
- Standards for legal, accounting and valuation opinions;
- Continuing oversight throughout proposal development by the general counsel;
- Specific internal evaluation and decision chain with respect to the proposal; and
- Absence of individual and organizational conflicts of interest

*As to the Basic Facts.* The governance review body should not be expected to have a mastery of the facts of individual alignment proposals—**that is the responsibility of management**.

Yet, there is value in the board having a working knowledge of the essential facts of individual proposals, as they may relate to such matters as:

- The genesis of the proposal;
- The parties to the proposal and their historical relationship to the health system;
- The remuneration elements being negotiated (e.g., proposed compensation, incentive payments, management fees);
- The outside experts engaged by the health system and their respective roles; and
- How the proposal is intended to serve the best interests of the health system, the communities it serves and the charitable assets it safeguards

*As to Reliance on Experts.* It is a general rule of corporate law that the governing board and its committees are entitled to rely on the advice of outside experts (and executive management), in the absence of information known to the board that would render such reliance unjustified.<sup>9</sup> The ability to rely on the advice of experts is critical to the ability of the board to exercise due care in the context of reviewing proposals for complex transactions such as physician alignment. There is an obvious, practical connection between the advice of experts and the exercise of prudence and good faith.

That being said, it is important that the governance review body, working in consultation with the general counsel, assures the reasonableness of such reliance by confirming certain facts about the experts (and, where necessary, the members of the management team also providing proposal information), such as whether:

- Each advisor is sufficiently qualified in terms of experience and expertise to provide the advice that has been requested;
- Any actual or potential conflicts of interest could affect the advisor's putative disinterest;
- The advisory work has been performed by the specific professionals who were selected by the organization;
- Well reasoned, written advice was provided; and
- The advisors had access to all the relevant facts.

*As to the Valuation Opinion.* Of course, the governance review body will want to confirm (where appropriate) that valuation and reasonableness opinions have been obtained with respect to the proposal. Beyond that basic confirmation, certain elements of the valuation/compensation process are by their nature well suited for greater board review. **This is not to suggest** that the governance review body must possess a detailed knowledge of the valuation process, substitute its judgment for that of the expert advisors, or review all aspects of the valuation and its conclusions.

**Rather, it is to suggest** that it may be appropriate for the board to review, at a high level, those portions of a valuation process (and those portions of the associated

<sup>9</sup> Model Act Section 8.42.

analysis) that are most likely to attract government attention, such as whether:

- The valuation or fair market value opinion was obtained after an agreement was reached;
- Pressure was placed on the valuation firm to change its calculations, change its methodology, or arrive at a particular number or qualitative conclusion;
- No effective procedure is in place for tracking the administrative services and time commitment to be provided by physicians, where separate compensation is paid for such services;
- There are statements in policies or valuation opinions that certain compensation arrangements are commonly accepted as being consistent with fair market value, without further written support or foundation; and
- There has been any change in the valuation of compensation arrangements – whether a change in methodology, a change in the firm conducting the valuation, a change in the surveys used, or a change in what the firm is willing to consider as fair market value.

These and similar examples relate to potentially problematic aspects of the valuation process that could be identified by a close review by the governance review body, as a supplement to review by senior management. They are the types of concerns that could be identified by the application of ordinary business judgment by a volunteer board member acting in good faith—the “Hey—this doesn’t seem to hang together” kind of concern.

*As to the Legal Advice.* Many of the same practical concerns referenced above with respect to the valuation opinion may similarly apply to the legal advice requested and received by the organization in connection with an alignment transaction. Depending on the circumstances, management representations that “the lawyers have signed off on the deal” or “legal has given us their opinion” may be insufficient to support the board’s evaluation responsibilities.

It may be appropriate for the general counsel to provide the governance review body with a high level overview of the advice. This would not only help assure that reliance is appropriate, but would also help the review body fully comprehend the scope of the advice and what it has to say about the legality of the proposal.

The review body’s ordinary business judgment could fairly be applied to basic elements of the advice, such as whether:

- The scope of the advice is consistent with the intended engagement;
- The facts on which the advice relies are accurate;
- There are any material exceptions, qualifications or limitations to the advice;
- The level of potential risk associated with the proposal is sufficiently and clearly described; and
- The advice speaks to the risk of illegality or risk of enforcement (or both), associated with the proposal.

Depending on the nature of the proposal, the governance review body’s deliberative efforts may be helped when it has a working understanding of the scope of the legal advice it is reviewing, and is thus in a better position to ask more informed questions.

This ties directly into the discussion above, about the benefits of review body awareness of the laws implicated by physician alignment transactions, and the associated legal risks. The more aware the review body is with respect to the level of potential legal risk associated with the transaction, the better prepared it will be to render a reasonable decision.

**Please Note:** *By this discussion, the authors are not suggesting the governance review body replicate the efforts of the management team in vetting the contents of the professional opinions or advice received in connection with particular proposals. We are, however, suggesting that the review body may be better prepared to evaluate the proposal, and reach an informed decision after applying an appropriate level of governance oversight, if it exercises its business judgment with regard to the basic elements of the professional opinions or advice.*

*As to Risk Profile.* The evaluation process should also include consideration of any organizational risk profile previously adopted by the board. Increasingly, boards across industry sectors are establishing internal guidelines with respect to the amount of legal, regulatory and other forms of risk (e.g., reputational) that would be reasonable for the organization to assume.

While this would require close coordination between the general counsel and outside advisors, it would likely involve the exercise of judgment by the review body as to whether the articulated risks associated with a particular alignment proposal would fall within a previously articulated policy or other guideline on acceptable levels of risk. This would include attentiveness to the potential for reputational damage to the organization from a legally controversial alignment proposal, and the organizational (and individual) burdens that might arise from a whistleblower or enforcement action.

*As to Financial Feasibility.* It is a natural and logical culmination of the evaluation process that the review body and/or the full board examine the financial feasibility and reasonableness of material physician alignment proposals, as part of its overall approval powers.

Governance consideration of the financial reasonableness of such proposals is directly related to its role as the steward of the organization’s assets and financial condition. This is a fundamental and necessary procedural check-and-balance to management-prepared initiatives. Yet, given the nature of the anti-fraud laws, this financial feasibility evaluation should be carefully conducted, with the advice of counsel.

In particular, any consideration by the review body or full board of the broader financial implications and feasibility of a physician alignment proposal should be clearly separated from the determination of the amount of compensation to be paid to the physicians involved. The compensation aspect of the arrangement should be negotiated at arms-length based on fair market value and without regard to any potential referrals from the physicians, and the review body’s consideration of the financial implications and feasibility of the proposed arrangement on the organization and its mission should be conducted separately.

In other words, the process of determining physician compensation should, to the greatest extent possible, be “firewalled” from any consideration of the overall financial effect of the transaction. The overall financial feasibility analysis (e.g., consideration of the capital costs, staffing requirements and overall affordability of the transaction) likely will reflect, to some extent, assumptions about revenues as well as expenses.

It will be important to be able to demonstrate that the process of setting compensation, and any subsequent review and adjustment of compensation, did not take into account any financial feasibility analysis that could have considered downstream financial impact.

### Board Liability Exposure

As a general matter, it is *very rare* that health care governing board members are held responsible for civil or criminal violations of the law, whether for their own conduct, or for conduct associated with the activities of the organization. This is *especially the case* with respect to voluntary board members of nonprofit health systems. Indeed, the authors are unaware of any action in which an enforcement agency has sought to hold health system board members personally liable for non-compliant physician alignment arrangements.

Nevertheless, this is an understandable concern given (a) the dramatic evolution of the health care sector; (b) the increased level of health care anti-fraud enforcement activity; (c) the role of state attorneys general in pursuing instances of breach of fiduciary duty in the nonprofit sector; (d) and the willingness of third parties (e.g., shareholders and committees of unsecured creditors) to protect their own interests. In that regard, the circumstances surrounding the prominent 2013 *Tuomey Health System* case provide an interesting—although perhaps extreme—perspective on the board’s risk profile.

For example, a September 3, 2013 opinion of the South Carolina attorney general<sup>10</sup> concluded that Tuomey officers and trustees could not be indemnified for penalties associated with the May 8, 2013 jury verdict in the case. It was in the context of that verdict that the opinion was sought from the attorney general on the ability of a charitable, nonprofit corporation (Tuomey) to indemnify its officers and trustees from litigation-associated penalties.

According to the attorney general, indemnification would be inappropriate where the officers and directors had not been named as defendants and thus were not compelled to pay damages (as was the circumstance at the time the opinion was issued). In other words, the indemnification issue was not “ripe.”

However, the opinion created the potential for misunderstanding to the extent that it suggests that South Carolina charitable trust law may actually “trump”

state nonprofit corporation law as to the prevailing standard for director liability (i.e., “simple negligence” v. “gross negligence”). The attorney general’s opinion applies South Carolina law, and arose in the context of a contentious enforcement action involving highly unusual facts. It reaches no conclusions about the conduct or culpability of the Tuomey trustees.

Further, the *Tuomey* facts are unique, so as to make it very difficult to use those facts to support or lead to any broad generalizations on the resulting impact on liability exposure for board compliance oversight.

However, the issuance of the opinion, regardless of its limited application, has prompted a broader discussion about directors’ access to indemnification and insurance protections—particularly in situations where, like the *Tuomey* case, the role of the board in its oversight of physician contracting arrangements was a matter raised by the government:

*“It is Tuomey’s own management and board who are responsible for permitting the damages and penalties to amount to the level ultimately found by the jury. Tuomey’s executives and management decided to throw caution to the wind and refused to terminate the contracts until the first jury declared them illegal.”<sup>11</sup>*

### Sensitivity to Internal Tensions

An important board oversight role could be the board’s sensitivity to associated unique, internal tensions within the management team. In highly competitive markets, senior management may be more willing to truncate established approval processes, and to advocate for high risk transactions, based on a good faith belief that a transaction is important to the health system.

In such situations, extraordinary pressures may be placed on the internal legal team to provide the legal support for otherwise risky transactions. These tensions and pressures create the potential for a distorted review process. The board must be alert to the potential for such tensions and take affirmative action to reduce their impact on the approval process.

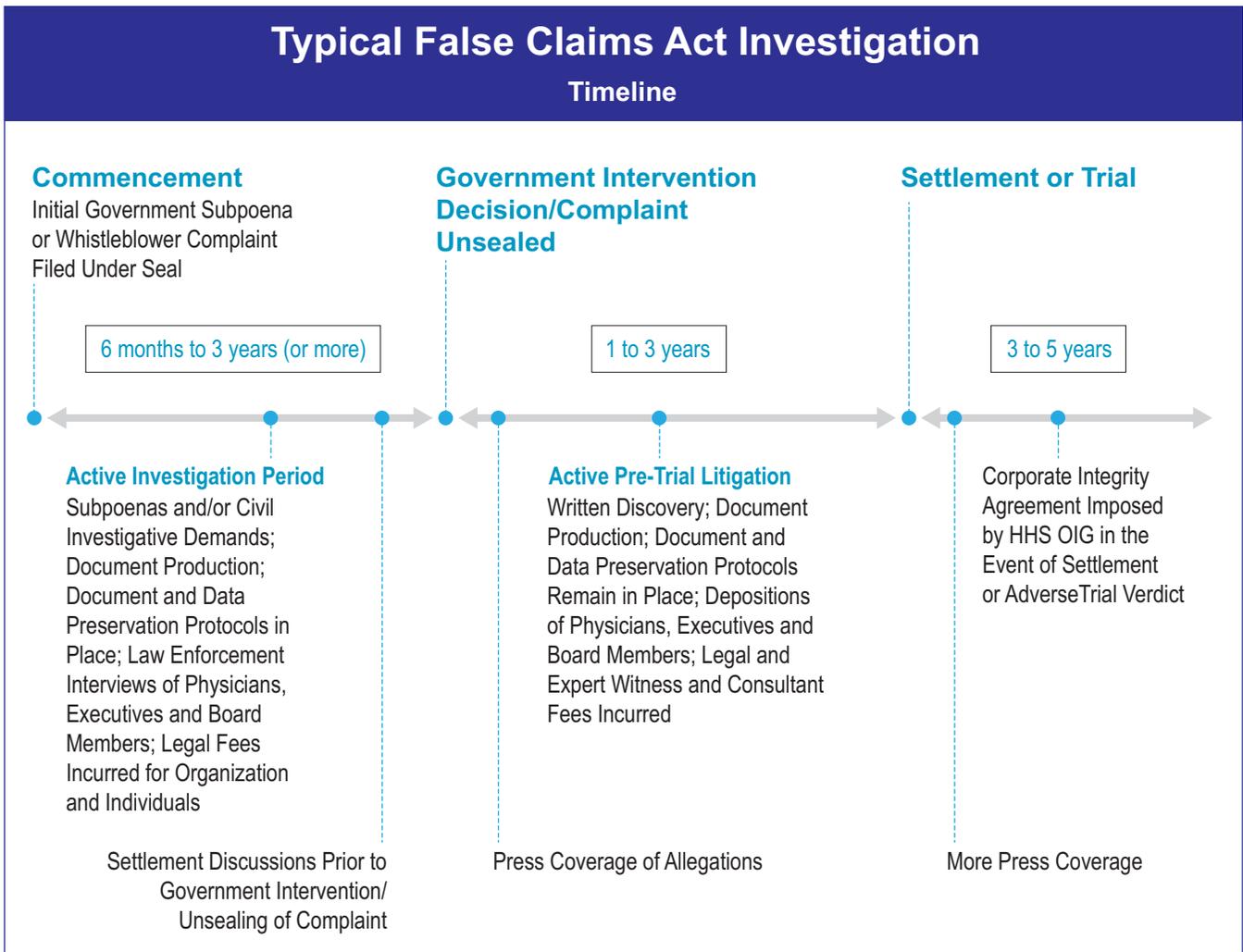
### Conclusion

Let’s be clear. This approach is not presented as a statutory or regulatory requirement, nor as “best practice.” Failure to proceed in this direction should not constitute a breach of fiduciary duty. Yet the trends and indicators are quite consistent, and they suggest, at least to us, that the greater the degree of board engagement in the physician alignment process, the less likely that severe regulatory risks will arise.

The health system general counsel serves his or her client well by recommending a board/management dialogue on the issue of appropriate governance oversight of physician alignment strategies and proposals.

<sup>10</sup> Letter of Alan Wilson, Attorney General of South Carolina, to The Honorable J. Thomas McElveen, III (September 3, 2013).

<sup>11</sup> *Drakeford v. Toumey Healthcare System, Inc.*, Reply in Support of United States’ Motion For Entry of Judgment Under The False Claims Act (Filed June 24, 2013) (Pages 20, 21).



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