

*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. CONFLICTS OF INTEREST

The process by which a nonprofit board reviews potential conflicts of interest is as important as the need for individual directors to make full disclosure of such potential conflicts. This was demonstrated recently by **media reports** focusing on a conflict of interest arrangement involving adult siblings, one of whom was a board member of, and the other a vendor to, a nonprofit community hospital. According to the reports, the sibling board member is a judge in the law division of the county circuit court, while the sibling vendor is a lawyer in a law firm that regularly represents the hospital on malpractice matters in the circuit court. Appropriate disclosures were apparently made, and it is within a board's authority to authorize conflict of interest arrangements under certain circumstances. However, increasing concerns about reputational harm may place a higher burden on the thoroughness of a board's conflict review process in general, and the reasonableness of conflict management plans in particular.

## 2. BREACH OF FIDUCIARY DUTY

The willingness of the attorney general to pursue breach of fiduciary duty actions is well demonstrated by a **recent Illinois Appellate Court decision**, affirming a prior summary judgment decision in favor of the state against a nonprofit nursing home, and certain members of its board and executive management team. The action arose from the decision of the home's executive director to sell the home to a third party; from the failure to report the transaction to the state as required; and from the action of the executive director in writing herself a \$2 million check, allegedly in repayment for personal loans she had previously extended to the nursing home corporation. The Appellate Court affirmed a series of substantial judgments, including a personal judgment against the executive director for the amount of the repayment; the removal of the executive director and several officers and directors; the dissolution of the nursing home corporation and the distribution of its remaining assets pursuant to *cy pres* principles. Note that this action was brought under the state's Charitable Trust Act, as opposed to the Nonprofit Corporation Act or common law.

## 3. THE "DISTRACTED DIRECTOR"

A recently published **academic paper** brings renewed attention to governance concerns associated with directors who may be "over-boarded", or distracted by other relationships. Concerns associated with "director busyness" prominently arose as part of Sarbanes-era governance reforms. This new paper confirms the view that additional demands on directors' time (*e.g.*, from other board service) can have a detrimental effect on board oversight quality and mission achievement, particularly when the board's agenda is increasingly complex. While many publicly traded companies impose restrictions on the number of outside directorships held by their independent directors, such a practice is not commonplace with large nonprofit health systems. Greater demands on nonprofit boards, and increased competition among nonprofit corporations for the most qualified board candidates, combine to push issues of "director busyness" to the forefront of Nominating Committee dialogue.

## 4. AUDITOR INDEPENDENCE

General counsel should discuss with the audit committee a subtle "uptick" in focus on the important corporate responsibility issue of auditor independence. A recent article in **The Wall Street Journal** profiled a discreet regulatory emphasis intended to prevent "scope creep"; *i.e.*, when the nature of auditor consulting services changes over time to relationships that might threaten independence. Indeed, in January, a major accounting company paid an \$8.2 million **fine to the SEC** to resolve allegations that certain of its consulting practices violated independence rules. The rationale supporting auditor independence rules has strong policy applications for large nonprofit health systems that may have otherwise appropriate reasons to engage the consulting services of their audit firms. Indeed, there have been notable instances where auditor independence concerns have been cited by attorneys general in their compliance reviews of nonprofit business practices.

## 5. EXECUTIVE COMPENSATION

Several new developments are worthy to be shared with the executive compensation committee for its consideration. First, the Chair of the House Ways & Means Committee (Dave Camp, R.-Mich.) recently introduced a **tax reform legislative proposal** that addresses tax-exempt organization executive compensation issues. One Section would impose a 25% excise tax on executive compensation over \$1 million, and any excess parachute payments, paid by an exempt organization to any of its five highest-paid employees. A second Section would eliminate Section 4958's rebuttable presumption of reasonableness and replace it with certain "due diligence" procedures. Exempt organizations would become subject to a 10% excise tax on any excess benefits. Second, HHS/OIG is pursuing, as part of its **2014 Workplan**, what it refers to as an "audit of excessive compensation" at Medicare-participating hospitals. Audit results will be used to help evaluate possible limits on the amount of compensation that could be submitted for reimbursement on future cost reports.

## 6. MERGERS & ACQUISITIONS

The strategic planning committee would benefit from an interesting recent feature in the **Boston Globe**, detailing the demise of merger discussions amongst three premier Eastern Massachusetts health systems. According to the Globe report, while the parties were united with respect to a shared vision of more affordable care, differences arose on matters of executive leadership, and on how the merger would benefit individual participants. The article provides an informative snapshot of the differing types of strategic visions held by health systems, the challenges often encountered when large health care systems embark on collaborative discussions, and on the fluid—and often acquisitive—nature of the health care market in many of the largest metropolitan areas of the country. As such, the article is a useful primer for the boards of nonprofit health systems ready to embark on ambitious collaborative strategies.

## 7. NACD GOVERNANCE SURVEY

The newly released 2013-2014 **NACD Nonprofit Governance Survey** from the National Association of Corporate Directors is likely to be a useful resource for many nonprofit health system boards. The survey data—which covers a wide section of nonprofit organizations—reflects a series of interesting observations on trends towards increased oversight, including: heightened director time commitment on board-related matters, a gradual shift to smaller boards, increasing diversity within the board, use of tenure limiting mechanisms, and - interesting - less planning for (and greater discontent with respect to) executive succession. Boards should not assume that survey results are the equivalent of legal standards or best practices; rather, they are a "snapshot" of popular practices. Nevertheless, any survey conducted by an organization as estimable as the NACD is worthy of close evaluation by the governance committee of a nonprofit health system.

## 8. A CURIOUS TALE

The **saga of the nonprofit National Museum of Industrial History** bears monitoring. Despite allegedly raising over \$17 million in funds for museum development (and spending over \$8 million in developmental costs) over the past ten years, the museum itself is unbuilt. Indeed, the organization's operating practices were the subject of a recent county criminal grand jury investigation. The grand jury report found no evidence of criminal activity, but recommended that the Museum CEO resign (due to lack of qualifications), or that the Museum board chair terminate him and hire a more qualified CEO. It further recommended that the board pursue legal action against the CEO for negligence and contractual breach. However, the board has so far declined to adopt the grand jury's recommendation and has retained the CEO, but at a reduced salary. This presents an interesting fiduciary issue. Are there circumstances in which a nonprofit governing board can reject the explicit *recommendations* of a law enforcement agency or judicial body while remaining faithful to its duty of care obligations?

## 9. BOARD COMMUNICATION AND DECISION MAKING

Another new **academic study** offers a provocative evaluation of factors that may materially impede board level discussion of important issues. Particular focus is made on the value of director discussions outside of board meetings; on the types of "personal costs" that may prevent a director from communicating her position fully and openly (e.g., fear of retaliation, of appearing less than competent, of being perceived as a "troublemaker"); the risks arising from the desire to achieve conformity (and indirectly, unanimity); the implications of secret v. open balloting; and the effects of conflict of interest on a director's incentive to communicate a position. As courts and regulators place an increasing emphasis on the record made at board meetings, there is greater value in addressing barriers to open and effective communication amongst directors.

For additional information on any of the developments referenced above, please contact Michael at +1 312 984 6933 or at [mperegrine@mwe.com](mailto:mperegrine@mwe.com); or visit his publications library at [www.mwe.com/peregrinepubs](http://www.mwe.com/peregrinepubs).

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