Presentation of Michael W. Peregrine
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Contents
October 17 Slide Deck
Compilation of Peregrine 2016
Nonprofit Corporate Law & Governance Newsletters
Principal Nonprofit Corporate Law & Governance Trends and Developments

NAAG/NASCO
Regulation and Oversight of Nonprofit Organizations Conference

October 17, 2016

Where I Want to Go

1. To share a perspective on the leading corporate and governance law trends and indicators affecting nonprofit organizations in 2016 (to date).

2. To offer suggestions on ways in which corporate counsel may work with charity regulators in effectively and efficiently responding to those trends and indicators.

3. To comment on emerging nonprofit corporate law and governance trends, against the backdrop of several premises and perspectives.
First:

Michael Peregrine’s views do not necessarily reflect the views of McDermott Will & Emery LLP, or its clients.

Second:

- The Materials
- How to Obtain Copies of Referenced Cases and other Developments
- Peregrine’s Mailing List: Publications Library, Newsletter
Trend #1: “The Summer of Governance Principles”

- Over a one month period, two important commentaries on corporate governance were released by leading business/CEO consortiums.
- Both offer serious recommendations on critical elements of governance that affect sophisticated nonprofit corporations.

Trend #1: “The Summer of Governance Principles” (cont’d)

- The release of either of these two commentaries would have been a significant event worthy of governance committee attention. For two sets of substantial commentaries to be released in close proximity is particularly consequential.
Trend #2: Director Engagement

- The extent of director engagement is drawing increasing attention as nonprofit boards become more operationally sophisticated.
- “Engagement” generally refers to the level of commitment of the director to his/her fiduciary duties given the circumstances at hand.
- As nonprofit agendas become more complex, it may be appropriate to expect a level of director engagement that is commensurate with that complexity.

Trend #3: Director Overboarding

- Closely related to engagement is the question of participation on the boards of other corporations
  - For-profit and nonprofit
  - At what point is effectiveness diminished?
  - “Community Leaders”
Trend #4: “Seismic-Level” Strategic Planning

- Certain legislative and regulatory developments are of such fundamental significance to nonprofit operations that they require special board and key committee focus.

- A primary example comes from health care: the implications of the payment transformation from fee-for-service payments to other types of payment models under MACRA. These transformative developments implicate the charters of many key board committees.

Trend #5: Preserving Board Defenses

- The increasing scrutiny of board conduct that we see coming from multiple directions will strongly motivate the board to preserve the availability of key process-related defenses.

- These include the business judgment rule, good faith conduct, reliance on experts and counsel, and the attorney-client privilege. All of these defenses have come under increasing pressure as judicial decisions and regulatory positions have exposed weaknesses in their application.
Trend #6: Diversity as a Governance Best Practice

- A leading governance and regulatory theme is an enhanced focus on diversity in the board nomination process.
- This reflects a perspective that more diverse boards— including directors who represent the broad range of society--will strengthen board performance and contribute to the fundamental goal of creating long term shareholder value.

Trend #6: Diversity as a Governance Best Practice (cont’d)

- BRT: “develop a framework for identifying appropriately diverse candidates that allows the nominating/governance committee to consider women, minorities and others with diverse backgrounds as candidates for each open board seat”.
The nonprofit’s compliance committee can expect to have an unusually busy agenda for the foreseeable future. This is in large part due to:

- The substantial increase in FCA penalties and the related impact on risk evaluation;
- Application of Yates-based principles to enforcement actions involving laws (e.g., public health and safety, antitrust) that are not solely fraud-based; and
- The anticipated release by DOJ of compliance program effectiveness metrics.

See, e.g., recent FCA and Stark settlements involving officers and directors; waiver of right to indemnification.
Trend #8: Board Refreshment Concepts

- Multiple external constituencies are prompting further attention to formal director refreshment policies.
- While there remains no “best practice”, these perspectives reflect relevant-to-nonprofits concerns with director tenure, evaluation, succession planning and fitness to serve.

Trend #8: Board Refreshment Concepts (cont’d)

- Key topics include the relationship of tenure to entrenchment and independence; the utility of turnover to encourage board diversity and blend of necessary skills; the benefits of director evaluation; and the correlation between length of service and corporate performance.
Trend #9: “Constituent Representation”

- Large nonprofits are being forced to address unique conflicts issues arising from “constituent” governance arrangements.
- Such arrangements may create confusion as to the proper fiduciary relationship; “what hat am I wearing?”
- Specially designed conflicts protocols are often necessary in order to address the potential for board deadlock.

Trend #10: “Optics” Increasingly Count

- Governance committees may need to confront arrangements that create the “appearance of conflict”.
- In many instances, the optical risks of these arrangements can cast an “ethical shadow” over the organization.
- This may occur even when board processes were followed, or an actual conflict is determined not to exist.
- The fiduciary duty connection.
Trend #11: Governance, and Regulatory Oversight

- The list of regulatory and other parties that are scrutinizing the role of nonprofit corporate governance is increasing.
- Traditional interested parties extend beyond state charity officials to include the IRS, bond rating agencies and creditors.
- Increasingly, we see interest from DOJ, OIG and even the SEC in certain circumstances.
- The implications of the Hershey Trust settlement.

Trend #12: “Grassley’s Back”

- Focus on overhead costs (e.g., travel, hostel, conferences) of nonprofits under scrutiny;
- IRC Sec. 501(r) and hospitals’ ‘management’ of their relationship to low income communities.
- Kosiken correspondence.
- 20th Anniversary of IRC 4958.
Trend #13: Centralization of Governance Authority

- Many large nonprofits are pursuing centralization of system authority within the parent organization in order to improve system management.
- This is in direct reaction to the perceived inefficiencies, intra-system communication barriers and board/administrative burdens arising from the proliferation of corporate entities and separate governing boards within the system.
- More extensive “upstream” delegation of corporate authority and streamlined governance/decision-making structures are often used to achieve the desired centralization.

Trend #14: Compensation of Board Members

- An increasing matter of interest in nonprofit sector given greater responsibilities, risks associated with board service.
- Competency-based governance.
- Tied to evaluations, limits on other board service.
- Manner of, and approval, of compensation.
Trend #15: Greater Focus on Role of GC

- Increasingly acknowledged “best practice”: prominent GC as business partner of management.
- Impact on attorney client privilege.
- Continuing litigation regarding ethics:
  - “Reporting Up and Out”
  - Who is the GC’s client?

Conclusion
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:

STRATEGIC PLANNING AND ANTITRUST LAW
The board’s strategic planning activity should be informed by recent aggressive action by the antitrust enforcement agencies. Most notably, the FTC has filed three separate formal challenges to hospital mergers. These challenges reflect, among other factors, the FTC’s willingness to challenge transactions in large metropolitan areas; its rejection of certain types of “efficiencies” arguments; and the unpersuasiveness of certain types of merger support from otherwise influential third parties. Separately, the FTC has rejected the notion of conflict between the ACA and the antitrust laws. | Read more

“PRACTICE LOSSES” AND ENTERPRISE RISK
Three recent FCA settlements involving Stark law allegations may also have unexpected governance implications. To varying degrees in each of these settlements, the DOJ appears to advance the highly controversial position that Stark is violated when a health system pays employed physicians more than the net professional income the physician generates. Obviously, DOJ’s formal pursuit of such a theory could be problematic to IDSs. Thus, DOJ’s position is the type of information that could usefully be disclosed through the board’s enterprise risk management process. | Read more

GOVERNANCE AND “CHILLED” GATEKEEPERS
An emerging governance challenge is the need to address the tension between the pursuit of legitimate corporate strategic goals, and the concerns of internal “gatekeepers” who perceive themselves at increasing personal legal risk for corporate wrongdoing. This challenge is a direct byproduct of new DOJ and SEC enforcement initiatives. The concern is that some gatekeepers may become more self protective in the performance of their duties, creating barriers to the implementation of legitimate corporate strategy. Attentive boards will engage with gatekeepers on this concern. | Read more

APPEARANCE OF CONFLICT
A recent The Wall Street Journal story addresses “appearance of conflict” issues that can arise from charity operations. The subject charity provides decorations to be placed on military graves. It allegedly purchases the decorations from a company operated, and in part governed by, the charity’s founding family. Particular focus was on the terms (e.g., price, exclusivity) by which the charity purchases the decorations. The story is a reminder that while applicable law may allow a charity to purchase goods and services from board members or their affiliates, the practice may lead to increased scrutiny. | Read more
M & A ENFORCEMENT DAMAGES

On December 9, a Missouri state court directed HCA (and its acquisitions affiliate) to pay $434 million for breach of specific post closing commitments made to a Kansas City health foundation in connection with HCA’s 2003 acquisition of the Health Midwest system. This decision (likely to be appealed) is a prominent example of how disputes on the interpretation and implementation of post-closing commitments can escalate into lengthy, involved controversy—and even litigation. Such commitments can often have a long—and unpredictable—“shelf life”.| Read more

INDEMNIFICATION POLICY REVIEW

A series of recent developments serve to identify new sources of potential director and officer liability exposure. One (but certainly not the only) of these developments is the broad application of DOJ’s “Yates Memorandum” holding individuals accountable for corporate civil and criminal wrongdoing. These should prompt the Governance Committee to review the breadth and effectiveness of existing protections afforded key fiduciaries. These protections are typically contained in indemnification provisions of the corporate bylaws, in individual indemnity agreements, and in key provisions of “D&O” insurance. | Read more

“REPORTING UP” OBLIGATIONS

New developments have arisen in the important professional responsibility case formerly referred to as Redacted v. Redacted. This case (still ongoing) expressly addresses the application of Professional Rule of Responsibility 1.6 (“Confidentiality”) to the actions of the (former) general counsel of a nonprofit corporation, who reported her concerns about director malfeasance directly to the state attorney general. On December 10, various court documents relating to the proceedings were unsealed, including the April 30, 2014 Commonwealth Court opinion (thus publicly identifying the parties). | Read more

COMPLIANCE PROGRAM EFFECTIVENESS

Both the Audit and Compliance committees should consider the new compliance program guidance provided in a recent speech by the head of DOJ’s Criminal Division. The guidance offers a series of practical metrics that are intended to measure compliance program design and good faith application. Its release coincided with DOJ’s appointment of a “compliance counsel” to advise prosecutors as they consider in particular cases the effectiveness of an individual corporation’s compliance program. Both developments address issues of interest to audit and compliance committees. | Read more

FOCUS ON DIRECTOR PERFORMANCE

December saw substantial commentary on several critical elements of director performance. A new Equilar study reported sharp increases in director compensation among S&P 500 companies. The study did acknowledge, however, an increase not only in director workload, but also in exposure to risks and responsibilities. A Boston Globe feature was critical of the effectiveness of directors who serve on multiple corporate boards. A prominent observer publicly described robust annual board and committee evaluations to be “best practice” and necessary to reduce overboarding risks. | Read more

PIERCING THE CORPORATE VEIL

Health system general counsel may draw comfort from recent decisions that preserve a high bar for plaintiffs seeking to “pierce the corporate veil” and attribute liability to a parent company or shareholder. A new Delaware Chancery Court decision reiterates the traditional test to be met in order to sustain a veil piercing claim (e.g., “sham entity designed to defraud investors and creditors”). Yet, the new decision also prompts general counsel to review the extent to which system affiliates satisfy mission, capitalization, solvency and corporate formalities thresholds. | Read more

NEWEST PUBLICATIONS:

- Governance Challenges When Gatekeepers are “Chilled”
- Top 10 Health Law Developments In 2015 And What’s Ahead
- Caution by Company Officers Can Create Problems for Boards
- The ‘Practice Losses’ Theory as an Enterprise Risk

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WHO IS THE GC’S CLIENT?
A trio of new state appellate court decisions bring into sharp focus the question of who—or what—is the general counsel’s client, particularly in the context of a legal proceeding or investigation involving interaction with officers and/or directors. In each case, the appeals court ruled that the general counsel breached the attorney-client privilege that had existed for communications between her and three corporate executives. The decisions underscore the importance of properly communicated “Upjohn” warnings to corporate executives. These are particularly timely issues given the new Department of Justice focus on individual culpability. The new decisions also provide an important opportunity for the general counsel to confirm fundamental representational matters with her internal clientele. | Read more

THE NEW ACC SURVEY
General counsel may wish to share with corporate leadership the principal conclusions from the 2016 Chief Legal Officers Survey published by the Association of Corporate Counsel. Prominent areas of general counsel concern reflected in the survey data were ethics and compliance issues, regulatory challenges and cybersecurity matters. Over one-third of respondents reported that their organization had been the subject of a regulatory enforcement action in the prior two years. The survey also reflects a significant growth of both legal department budgets, and in legal operations staffing. | Read more

ADDRESSING “OVERBOARDING” ISSUES
Recent articles in both The Wall Street Journal and in The Boston Globe cast renewed focus on the governance effectiveness issues with directors who serve on multiple boards. The articles referenced concerns from such groups as activist investors and state pension funds that director workload should be regulated. NACD statistics were cited on the average number of hours that directors spend on individual board service—with commentary on whether oversight capabilities are diminished when directors serve on multiple boards. Boards are increasingly establishing service limits for their members. | Read more

D&O COVERAGE ASSUMPTIONS
A recent article addresses the “nightmare” scenario of “unfounded assumptions” regarding D&O insurance coverage. The article pointed to a recent Court of Appeals decision involving a D&O coverage-based discovery dispute in which counsel made an assumption on the lack of coverage (based in part on the fact that no officer or director was named in the dispute). The article is a useful reminder for the general counsel to be mindful of the full scope of coverage of available D&O coverage, particularly given the current enforcement environment. Clarity on the full scope of D&O coverage is increasingly important for both corporate officers and directors in the wake of the Yates Memorandum and similar government enforcement policies focused on individual liability. | Read more
“CAREMARK” PLEADING BURDENS

A recent U.S. Court of Appeals decision offers both a strong defense of standard Delaware exculpation provisions included in corporate charters or bylaws, and a confirmation of the difficulty of pleading violations of Caremark-based claims of breach of director oversight duties. The underlying claims related to oversight of compliance with Medicare and Medicaid billing requirements. In its decision, the Court of Appeals acted to affirm the dismissal of a purported shareholder derivative claim of oversight liability arising from Madoff-based investment losses. It confirmed that Caremark claims must be based on allegations of “conscious misconduct”. | Read more

POSSIBLE AUDIT COMMITTEE EXPOSURE

The audit committee may wish to note a January 25 speech by a senior SEC official, discussing the Commission’s continuing focus on the audit committee and other financial reporting “gatekeepers”. This focus is part of the SEC’s overall emphasis on improving the financial reporting process, and pursuing related deficiencies. Indeed, the SEC has brought several enforcement actions against audit committee chairs in the last several years. While the SEC is not a primary regulator of nonprofit health system financial reporting practices, its enforcement posture offers helpful guidance on conduct that could attract the attention of a state attorney general or other charity regulator. | Read more

LAWYERS AS BOARD MEMBERS

A recent media story spoke to the increasing governance practice of nominating lawyers to serve on corporate boards. Historical concerns that lawyers were too risk-averse to be effective in a governance role are now more often offset by a recognition of the analytical and professional training skillsets they can contribute in a ‘corporate responsibility’-focused environment. Those benefits do not automatically extend to appointing the general counsel to the board, however. Such a practice can, in some situations, create “near insoluble” conflicts/professional responsibility issues. | Read more

DIRECTOR INDEPENDENCE “GREY AREAS”

“Positional independence” (i.e., the separation between oversight and management) has been a governance consideration since the Sarbanes Oxley era. Implicating both tax and corporate laws, the policy goal is that at least a majority of board members must consist of “independent” directors; i.e., independent of management. Yet, difficulties can arise in applying a comprehensive definition that eliminates bias concerns. The Wall Street Journal recently profiled certain personal and business relationships that, while falling outside traditional “independence” definitions, can create the potential for compromised director judgment. These are relationships that often arise in nonprofit health system boards. | Read more

COMPLIANCE OFFICER CONCERNS

General counsel and the audit/compliance committee should be sensitive to compliance officer personal liability concerns arising from two new developments. First is a recent series of SEC enforcement actions against compliance officers working in the investment adviser sector. Indeed, the SEC’s Enforcement Division has identified three categories of conduct that could expose compliance officers to scrutiny and potential liability. Second is proposed New York State regulations that would allow state officials to pursue criminal liability against compliance officers for false certification of certain regulatory reports. Both of these developments have been highly publicized in the compliance officer industry and are prompting significant CCO consternation. | Read more

COMMITTEE SIZE

A new article in The Wall Street Journal examines the facility of the two-person board committee, as is being applied by some companies. The size of board committees is usually regulated by state nonprofit corporation law. A two-person committee may be appropriate under many state laws (e.g., "shall consist of one or more directors") and, as The Journal article suggests, it may offer certain governance efficiencies. It may also support the committee practice of smaller boards. However, as to matters of size, the Nominating & Governance Committee may choose to focus on assuring that committee composition is large enough to allow for the effective performance of committee duties. | Read more

NEWEST PUBLICATIONS:

• 2016 Governance Trends for Health Care Systems Podcast Transcript
• "Reporting Up" and "Reporting Out": Judicial Developments for the General Counsel
• Governance Challenges When Gatekeepers are "Chilled"
• Top 10 Health Law Developments In 2015 And What’s Ahead

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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:

NEW EMPHASIS ON ANTITRUST COMPLIANCE
The Audit & Compliance Committee may wish to initiate steps intended to increase board, executive and organizational compliance with the antitrust laws. This, given the specific, new Department of Justice focus on prosecuting individuals for criminal antitrust violations. Recent speeches by senior DOJ Antitrust Division officials make it clear that the Division will vigorously apply the Yates Guidelines to criminal violations of antitrust laws, and may probe the corporate management structure to identify allegedly culpable individuals. Antitrust violations that typically risk criminal prosecution are price-fixing and market allocation; others are challenged in civil proceedings.

EXECUTIVE CONFLICTS IN “M&A” EVALUATIONS
The Yahoo Board recently decided to exclude both its CEO and CFO from Board M&A Committee deliberations. This decision highlights the value of sensitivity to potential conflicts of senior executives in health industry change of control situations. These may arise from retention agreements, severance rights and similar traditional benefits. They can also arise from equity interests in affiliates, job offers from the acquirer or unusual closing "incentives". None of these should preclude close executive involvement in the transaction. However, board oversight is useful to avoid significant attorney general scrutiny.

DOJ SAMPLE CORPORATE COMPLIANCE QUESTIONS
More information has become available concerning the Department of Justice’s plan to release a list of questions that companies implicated in wrongdoing can expect to be asked by investigators concerning the effectiveness of their compliance programs. According to a senior DOJ Fraud Division official, the questions will address: (i) the perspective of employees on compliance program effectiveness; (ii) the compliance-based “tone at the top”; (iii) the extent to which compliance is a shared corporate responsibility; and (iv) the relative expertise of compliance staff. This information may be useful to the Audit & Compliance Committee as it evaluates compliance program effectiveness.

DIRECTOR TENURE
The debate on the relationship between director effectiveness and tenure continues at multiple levels. For example, CalPERS has been considering a revision to its global governance policy that calls for more rigorous board discussions on director tenure, evaluation and succession planning. CalPERS maintains that independent directors can be compromised after 12 years of board service. In addition, a recent academic article proposes the adoption of limitations on the amount of time a director could be considered “independent” for purposes of serving on key committees (e.g., the audit and compensation committees). This might be an option to formal board term limits.
BOARD INVOLVEMENT IN STRATEGY

A new KPMG governance analysis discusses the evolution of the board’s strategic planning role from “an annual review and concur with periodic involvement” to a continual dialogue that involves evaluating strategic options and challenging core assumptions. This evolution is prompted in large part by new levels of global uncertainty, technology developments and government regulation, all of which may affect business models and strategic plans. The analysis encourages directors to be sufficiently familiar with the premises on which the strategic plan is based, so that they may be better positioned to address material changes in the plan.

SURVEY: LEADING BOARD PRIORITIES

The new “2015-2016 NACD Public Company Governance Survey” provides substantial “fodder” for discussion by the governance committee of health system boards. The most relevant director priorities highlighted by the Survey include strategic planning and oversight; corporate performance; corporate growth/M&A; CEO succession; executive talent development; director turnover rate; overboarding and time commitment issues; the quality of information flow to the board, and board level cybersecurity knowledge. While not health-industry specific, elements of the NACD survey can serve as helpful examples in support of board and governance committee agendas and education.

DIRECTOR COMPENSATION

Recent media coverage of director compensation may increase the challenges associated with establishing and maintaining legally sustainable arrangements for health care boards. As a recent The Wall Street Journal article notes, increases in public company board compensation are attracting the attention of regulators, corporate constituents and the public. Some observers express concern about loss of independence of compensated directors. At the same time, there is a growing recognition that the duties, obligations—and risks—of board service have similarly increased. Well-crafted compensation plans will balance these various factors.

DIRECTOR CONFIDENTIALITY

The increase in highly proprietary information being discussed in health system board and committee meetings is attracting greater attention to fiduciary obligations associated with director confidentiality. The risk that sensitive corporate strategies could be exposed to competitors or other third parties is prompting many boards to consider formal, comprehensive confidentiality policies applicable to all directors (even those who are advisory in nature). As a recent article points out, these policies are often supplemented by periodic reminders of confidentiality obligations, tutorials on what may constitute proprietary data, responding to confidentiality breaches, and similar measures.

BOARD-MANAGEMENT RELATIONSHIPS

A new NACD publication alerts governance committees to challenges arising from the evolving board/management relationship. The publication’s premise is that the new, more volatile corporate environment serves to “blur” the traditional distinction between board and management roles. With their significantly increased responsibilities, board members are now much more engaged in corporate affairs; as manifested in a greater amount of time invested on both formal board matters, and on informal dialogue with management. Given this shift, the governance committee may wish to take steps to assure effective board-management dynamics, including role expectations and constructive interactions.

BOARD DIVERSITY

Matters of “diversity” continue to be a pressing board concern. For example, a new GAO study estimates that it could take more than four decades for women’s representation on boards to be on par with that of men’s. More recently, SEC Chair Mary Jo White spoke strongly in favor of the value of boardroom diversity; favoring a definition of diversity in certain SEC disclosure rules. These perspectives are increasingly difficult for boards to ignore, raise significant reputational risks, and thus commend a focused board nomination emphasis on diversity components.

NEWEST PUBLICATIONS:

- “Protecting the Compliance Officer: A Balanced Approach”
- “Who Is the General Counsel’s Client? New Developments”

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**NEW JOC DECISION**
A March 22 ruling of the 6th Circuit addressed the antitrust feasibility of a joint operating company. Reversing and remanding to the district court (S.D. Ohio), the Court of Appeals interpreted the record (which included a lack of shared assets by the defendants) as presenting a genuine issue of material fact as to whether the hospitals possessed “separate corporate consciences” or were a “single entity” for antitrust purposes (an important factor). To the 6th Circuit, the facts “suggest that defendant hospitals are actually competitors attempting to eliminate another competitor through concerted action.” | Read more

**THE COMPLIANCE OFFICER AS WHISTLEBLOWER**
A recent complaint involving the president of a major university highlights the concerns that may arise when a compliance officer becomes a whistleblower. The particular complaint was filed by a former deputy compliance officer, who claims she was forced to resign because of management retaliation when she pressed her concerns about alleged officer misconduct. Clearly, “CO” whistleblower complaints can have “outsized” impact. For that reason the Audit Committee may wish to carefully explain to COs the resolution of concerns they bring to the Committee—and the rationale for such resolution. | Read more

**MORE PRESSURE ON DIRECTOR TENURE**
While term limits are not “best practice”, lengthy director tenure is coming under renewed challenge. A recent The Wall Street Journal article highlights activist investor concerns with long-tenured directors. Data indicates that at nearly 25% of the largest U.S. corporations, a majority of the board has served for at least 10 years. There are certainly benefits associated with director experience and institutional knowledge. Yet, the article cites increasing concerns with the independence implications of large numbers of long tenured directors—implications which affect both for profit and nonprofit companies. | Read more

**GRASSLEY ON “EO” OVERHEAD COSTS**
Nonprofit health systems should note the recent Senate and media scrutiny of the overhead expenses of the “Wounded Warrior Project”. Sen. Charles Grassley has questioned the tax exempt status of the organization, given the allegedly large percentage of donations spent on items such as employee conferences, plane travel and hotel expenses. In response, system general counsel may wish to work with management and the appropriate board committee to assure that proper policies and records are in place to support the reasonableness of organizational overhead and executive discretionary expenses, particularly at the system parent level. | Read more
GCS AND THE “REPORTING UP/OUT” OBLIGATION

A state bar association recently elected not to sanction former in-house lawyers for their alleged failure to make necessary alerts concerning the risk of death or disability arising from an alleged defect in a company-manufactured product. This decision is a reminder to health system general counsel of the vicissitudes of the professional responsibility rule applicable to “reporting up” and “out” (e.g., Model Rule 1.6- “Confidentiality”). The circumstances that could “trigger” a reporting obligation to the board - or externally - may vary depending upon the specific state bar rules, and should thus be known to the general counsel and his/her staff. Consider also the potential quality of care implications of this obligation. | Read more

RANSOMWARE AND BOARD COMMITTEES

The general counsel (perhaps with the CISO) could brief key board committees on the significant increase in ransomware attacks against health care systems. These attacks are attractive to cybercriminals because they require less effort than capitalizing on the theft of sensitive data. In the most recent health system incidents, critical components of the providers’ networks were penetrated in a manner that had the potential to affect daily operations and even patient care (e.g., shut down the EMR system). OCR discusses Ransomware in a March 30 update. Such a board briefing may support board efforts to monitor organization data security practices. | Read more

EXECUTIVE SERVICE ON OUTSIDE BOARDS

A recent The Wall Street Journal article highlights the value many companies attribute to outside corporate directorships of executive team members. The sense is that such service supports a diverse business experience for its executive management. The general counsel may “flag” the key legal issues typically presented in such arrangements: whether such outside service materially infringes on the executive’s service to his/her employer; whether board compensation belongs to the executive or the corporation; the tax planning implications of that question; and whether potential conflicts arise from outside board service. A corporate policy governing such outside board service may be useful. | Read more

BOARD EMPHASIS ON ANTITRUST LAW COMPLIANCE

Increasing Department of Justice application of “Yates” principles to antitrust violations may prompt the general counsel to provide a focused education update to both the board/compliance committee, and senior executives. This education effort could address the types of criminal and civil antitrust exposure—beyond M&A transactions—cited with recent frequency by DOJ. It could also reference conduct that DOJ could potentially interpret as price fixing or market allocation, and on the types of (non-M&A) activity in the health industry sector on which DOJ has stated that its enforcement activity will be focused. | Read more

AG/FTC MULTI-STATE INVESTIGATION

The FTC and all 50 attorney generals recently announced the settlement of a joint complaint against four allegedly “phony” cancer charities and several related individuals, relating to allegedly fraudulent charitable solicitation activities. The settlements included financial penalties, corporate dissolution and, for the individuals, a ban on further nonprofit sector work. The successful conclusion of this joint complaint reflects the willingness of state AGs to cooperate with each other, and with the federal government, to enforce nonprofit laws. As such, it should be of particular interest to health systems operating in multiple states. | Read more

LEADERSHIP VIEWS ON TOP RISKS

A recent survey conducted jointly by a consulting firm and a major university indicates that regulatory change and heightened regulatory scrutiny are, for the fourth consecutive year, the leading organizational risks as perceived by the board and management. Such survey findings provide a useful opportunity for the general counsel to educate leadership on the value of investing in legal compliance, solidifying availability of key board defenses (e.g., the business judgment rule; reliance on experts) and clarifying internal lines of authority to facilitate timely and accurately upstream reporting to the board. | Read more

NEAREST PUBLICATIONS:
- Health Cos. Must Focus On Antitrust Compliance Beyond M&A
- Managing Gatekeeper Anxiety

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**EXPANDING ROLE OF GENERAL COUNSEL**

The April 12 survey report, “The Rise of the GC: From Legal Adviser to Strategic Adviser” concludes that (a) the role of the corporate general counsel continues to expand and evolve; and (b) as this role shifts, the perspectives of the general counsel are “uniquely positioned” to advise the board and management team on risk management and strategic decisions. This is consistent with the perspectives of leading corporate responsibility commentators, that the role of the modern general counsel includes not only providing legal advice, broadly defined, but also serving as a member of the “business team” and offering business, ethics and risk management advice to leadership. [Read more]

**STATE AG ENFORCEMENT ACTION**

According to media reports, the Pennsylvania Attorney General has taken action to enforce provisions of a 2013 governance-based settlement negotiated with several Hershey School entities. That settlement concluded a lengthy investigation of controversial real estate transactions entered into by the charity. Reportedly, the Attorney General now seeks to (a) remove three long-serving (e.g., ten years or more) board members; (b) reduce board compensation; and (c) have the board members personally assume the costs associated with an internal conflict of interest investigation. [Read more]

**ENTREPRENEURS AS BOARD MEMBERS**

A recent article in The Wall Street Journal speaks to the increasing interest of some companies in recruiting entrepreneurs to their governing boards. According to the article, this practice is often associated with a focus on performance and outcomes, the generation of ideas and improvement in morale, particularly in smaller companies. It can also result in an increase in long term value and a greater willingness to invest in research and development. Notably, though, some entrepreneurs may often be more willing to accept risks than directors from more mainstream corporate backgrounds, and may be less patient with the boardroom process associated with traditional governance structures. [Read more]

**BOARD OVERSIGHT OF COMPLIANCE**

Prepared comments of Assistant Attorney General Leslie Caldwell provide a useful summary for boards of the Department of Justice’s health care fraud initiatives. Of particular relevance are Ms. Caldwell’s comments on the formation of the “Corporate Health Care Fraud Unit”—including DOJ’s commitment to investigating large scale corporate health care fraud; the standards (including but not limited to compliance failures) used to evaluate and support criminal health care fraud investigations; and its willingness to pursue health care fraud “into corporate boardrooms and executive suites”. Ms. Caldwell’s comments are well-suited for distribution to the Audit & Compliance Committee. [Read more]
COMPLIANCE PROGRAM METRICS
A recent, detailed “open letter” to DOJ’s new Compliance Counsel (published in the Harvard Business Law Review) underscores the current state of uncertainty on how that Counsel will guide DOJ prosecutors in evaluating the existence and effectiveness of individual corporate compliance plans. The “open letter” serves in part to provide recommendations on how DOJ should implement its previously stated goal of establishing industry specific benchmarks by which individual programs may be evaluated. In that regard, the “open letter” provides a useful overview of the categories of compliance program benchmarking that DOJ may ultimately apply; a topic of significant interest to the Audit & Compliance Committee. | Read more

“PROFITABILITY” OF NONPROFIT SYSTEMS
A recent academic report published in Health Affairs has attracted national attention to the “profitability” levels of nonprofit hospitals and health systems. The purpose of the report was to determine the characteristics of the most profitable hospitals. It concluded, among other matters, that seven of the top ten most profitable hospitals (from patient care services) in the country were nonprofit organizations. This report is likely to draw unwanted new attention to the special corporate law and tax classifications of health systems. It should thus prompt the board to increase its efforts towards supporting and demonstrating the core nonprofit, tax exempt mission of the health system. | Read more

“BEST IN CLASS” COMPLIANCE PROGRAMS
The Audit & Compliance Committee may wish to review the newly released report, “Principles and Practices of High-Quality Ethics Programs”. The stated purpose of the Report is to identify specific principles and practices that characterize “high quality ethics and compliance programs”; i.e., those that transcend ‘minimum effectiveness standards’ such as those set forth in the Federal Sentencing Guidelines. Thus, the Report’s recommendations may prompt a useful discussion at the Committee level concerning the continued sufficiency of the core elements of the organization’s existing compliance program. | Read more

BOARD TENURE CONSIDERATIONS
The governance committee may wish to give some consideration to the perspectives of institutional investors, proxy advisory firms and governance activists on the subject of director tenure. While there remains no “best practice”, these perspectives reflect relevant-to-nonprofits concerns with the relationship of tenure to entrenchment and independence; the utility of turnover to encourage board diversity and blend of necessary skills; the benefits of director evaluation; analyses supporting individual director renomination; and the correlation between length of service and corporate performance. | Read more

MANAGING EXPENSE REPORTS
Inappropriate use of expense accounts or reporting of expenses have long been a significant liability “trip wire” for corporate executives and some board members, and a prominent source of whistleblower complaints. In that context, a recent article from The Wall Street Journal, “CFOs Get the Darndest Expense Requests”, may be informative to corporate leadership. While styled in humorous manner, the article underscores the breadth of controversial or problematic expense reporting practices. As such, it serves as a useful reminder to corporate leadership to review the effectiveness of internal policies with respect to the incurrence, and conflict-free, reporting and review of executive and boardmember expenses. | Read more

WAIVING FIDUCIARY DUTIES IN PARTNERSHIPS
A recent Delaware decision provides a helpful example of how partnership terms can serve to protect conflicted transactions from judicial review. In Dieckman v. Regency, the Court of Chancery upheld partnership terms that eliminated fiduciary duties and provided an explicit mechanism (i.e., approval by the general partner’s conflicts committee) for approving transactions between the limited partnership and its general partner (or the general partner affiliates). This decision -- including the benefits of waiving fiduciary duties -- may be particularly relevant for health systems that invest, directly or through affiliates, in limited partnerships that may give rise to potential conflicts of interest. | Read more

NEWEST PUBLICATIONS:
• “Reporting Up Obligations”
• “Managing Gatekeeper Anxiety”

FOR MORE INFORMATION
For additional information on any of the developments referenced above, or for copies of these latest articles, please contact Michael at +1 312 984 6933 or at mperegrine@mwe.com; or visit his publications library at www.mwe.com/peregrinepubs.
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. PROTECTING THE CORPORATE REPUTATION

An important fiduciary obligation of the board is to protect the reputation of the organization, as a significant enterprise asset. In that regard, the new academic study, “Scoundrels in the C-Suite,” from the Stanford Graduate School of Business, may be of particular interest to health system executive committees. The Stanford study examines actions that corporate boards take in response to executive behavior that, while ‘not illegal’, remains questionable or otherwise inconsistent with the interests of the company or its shareholders. Such questionable behavior includes, but is not limited to, conduct such as making controversial public statements, having relations with an employee or contractor, or developing a reputation for overbearing or verbally abusive behavior. The study also summarizes why responding to such conduct “matters.”

With respect to such behavior, the appropriate board response is often less clear than it would be in the case of allegations of illegal activity. To that end, the Stanford study examines the range of actions that boards often take in response to CEO “bad behavior.” Specific focus is placed on such considerations as: (i) when are allegations of bad behavior credible enough to bring to the board’s attention; (ii) what measures can the board apply to evaluate the impact on the organization of the alleged CEO behavior; and (iii) the possible utility in having the board be proactive in applying information-gathering tools to detect early sign of senior leadership misbehavior.

The Stanford study is a highly-useful resource on board oversight of organizational reputational matters. Certainly, there is risk that any formal board consideration of the study, and implementation of related protocols, could be unsettling to the board/senior management relationship. Yet, there may be real value in a board discussion on its obligation to investigate credible allegations that management has engaged in conduct inconsistent with corporate interests. Most of the study’s examples and observations are directly relevant to large nonprofit organizations such as health systems.

2. BOARD COMPOSITION—LESSONS FROM “ACTIVIST ENVIRONMENT”

The health system’s nominating committee can draw several important lessons on board composition and qualifications from the perspectives of “activist investors” in the public company sector. According to a new article authored by PwC consultants, the activists are seeking greater influence on board composition decisions in order to pursue their perspectives on director tenure, diversity, expertise, experience and accountability for board self-evaluations.
Many of these perspectives apply favorably to sophisticated nonprofit corporations, as well as to for profit companies.

For example, the article recommends that nominating committees utilize a board composition grid as a tool in helping to assure that the nomination process identifies candidates with skillsets the committee has identified as critical to board oversight of corporate affairs. The article also encourages nominating committee consideration of the full range of diversity concerns: gender, race, ethnicity—and also skills, backgrounds, personalities, opinions and experiences. Note, in this regard, recent media scrutiny of the lack of diversity of a leading communications company that, while making business efforts to appeal to a more diverse audience, is facing shareholder pressure given its decidedly non-diverse governing board.

The article also encourages nominating committee discussion on matters of tenure and mandatory retirement, and succession planning, citing the scrutiny several institutional investors apply to these important issues. (As noted in prior editions of this Newsletter, many leading investor groups express concern about lengthy tenure compromising director independence.) In an interesting aside, the article references investor organizations whose voting policies address nominating committee performance.

Much of the important deliberation on board composition and director refreshment is arising from the activist investor environment in the public company sector. Health system board nominating committees may find several useful lessons arising from the perspectives of the activist community in this regard.

3. “YATES” PUSHBACK

The Audit & Compliance Committee might benefit from a general counsel briefing on an important new “white paper” issued by the US Chamber of Commerce, “DOJ’s Threshold for ‘Cooperation’.” The white paper focuses on what the Chamber believes are challenges corporations are incurring when considering cooperation with the Department of Justice under its “Yates Memorandum” on individual accountability.

According to the white paper, a series of “unintended consequences” serve to complicate what otherwise would be a “straightforward” decision on whether to cooperate with the government. These include: (i) Yates risks alienating employees whose knowledge of the relevant facts makes them critical to an internal investigation; (ii) Yates can serve to complicate compliance by making employees reluctant to report instances of wrongdoing out of concern with being made a target of an investigation; (iii) Yates renews concerns about governmental pressure to waive the attorney-client privilege; and (iv) it can also serve to create tension between the organization’s counsel and executives on what should be disclosed to the government.

Yates has been an important consideration for corporate boards, which as a fiduciary obligation should give close consideration to seeking cooperation credit when responding to a governmental investigation. It has also served to spark the current environment that places increasing emphasis on individual accountability for corporate misconduct or harm. However, the “all-or-nothing” approach of Yates (as the Chamber describes it) could significantly complicate the board’s decision-making. The Audit & Compliance Committee would be an appropriate venue for a governance-based discussion of Yates’ implications and the Chamber’s report. This discussion would logically be led by the general counsel and the corporation’s outside white collar counsel.

4. COMPLIANCE PLAN EFFECTIVENESS

The Audit & Compliance Committee may wish to take note of recent comments from DOJ Fraud Section Chief Andrew Weissmann, on key criteria DOJ uses when evaluating the compliance program effectiveness of companies under DOJ investigation. According to media reports, DOJ applies a “standard question” it asks companies about their compliance program challenges, when they are making a presentation to DOJ about mitigating factors that should be considered in any resolution with the government over allegations of corporate misconduct. These media reports quote Mr. Weissmann as observing, “When we hear from compliance officers…one of the standard questions that we ask is, ‘What do you still need to work on? What’s not working?’” Mr. Weissmann is further quoted as saying that he believes it indicative of “a working compliance function” when there is internal organizational dialogue about compliance program challenges, and where compliance officers believe that “their program isn’t perfect” and that “there is room for improvement.”
These comments might prompt the Audit & Compliance Committee to engage in a more periodic and deliberate dialogue with the general counsel, chief compliance auditor and the internal auditor on compliance program effectiveness matters, specific challenges facing the compliance program, and suggestions on possible ways to overcome these challenges. This dialogue would be consistent with an increasing Committee focus on the elements of compliance program effectiveness, in advance of the release of (long awaited) program benchmarking metrics the DOJ previously indicated it would be preparing for public dissemination. Earlier this year, the DOJ released a seven-metric outline of what its internal compliance officer would apply when evaluating specific compliance programs, but the details beyond the outline remain outstanding.

Separately, the general counsel may wish to read the provocative new law review article, Corporate Governance in an Era of Compliance. The article offers provocative new observations on compliance program utility, and expresses concern with the difficulty in demonstrating the effectiveness of the compliance program. The article’s fundamental goal is to prompt further conversation amongst scholars, practitioners, prosecutors, and policymakers on the proper calibration of corporate governance and corporate compliance.

5. ACUTE CHALLENGES FOR BOARDS

The current edition of Corporate Board Member includes the results of a survey of 345 board members and general counsel on acute challenges confronting boards; i.e., issues that “keep them awake at night.” While a majority of those surveyed most likely came from the for-profit sector, their responses are of notable significance to large, operationally complex nonprofit organizations such as health systems.

The survey listed the following leading concerns for directors, in descending order of acuity: IT/cyber security; business innovation/disruption; enterprise risk management; shareholder activism/engagement and government investigations. Leading concerns of surveyed general counsel were similar, with government investigation and shareholder activism considered more acute than ERM. Of particular interest is that almost half of the surveyed directors said that their general counsel reports to them not only at each full board meeting, but also in private sessions. Even still, that suggests that approximately 20 percent of the surveyed directors do not receive a scheduled briefing from the general counsel. Survey comments also expressed concern that the frequency of general counsel presentations is set by management, “so you never know what you are not aware of.”

Particular value of the Corporate Board Member survey comes from the extent to which it promotes boardroom discussion on those issues that “keep them awake at night”; emphasizes the timeliness and context of risk reporting to the board, and underscores the benefit of frequent, scheduled and related interaction between the general counsel and the board.

6. M&A PLANNING

The board’s Strategic Planning Committee will want to closely track both the resolution of the several current hospital merger enforcement cases, and also in particular recent merger-related warnings to the health care industry from FTC and DOJ antitrust regulators. These comments, made at a May 12 American Bar Association conference, offer useful guidance on the regulators’ perspective on using projected efficiencies to justify proposed mergers, as well as other regulatory observations on health care merger enforcement.

Several major themes are projected by the regulators’ comments. One, not surprisingly, is to give greater consideration in the strategic process to less-than-merger relationships with competitors; e.g., legitimate joint venture arrangements. Another is the difficulty in demonstrating a range of post-closing efficiencies sufficient to offset regulator concerns about a merger’s likely effect on competition.

Particularly relevant were comments by FTC Chairwoman Edith Ramirez, who expressed substantial concern with the rapid rate of consolidation among health care providers. She referenced an 18 percent increase in hospital mergers from 2014 to 2015 and a 70 percent increase since 2010. “While most provider mergers are not anticompetitive,” Ramirez is quoted as saying, empirical research by economist Marty Gaynor “found that the disparity in hospital prices within regions is the primary driver of variation in health care spending for the privately insured.” Gaynor’s study “shows that hospitals that face fewer competitors have substantially
higher prices, controlling for quality differences.” These regulatory perspectives can be helpful in positioning the Strategic Planning Committee to make more informed decisions with respect to merger/acquisition opportunities with possible competitors.

7. CONFLICTS OF INTEREST

The board’s Conflicts of Interest Committee might benefit from reviewing the now-public letter from the Pennsylvania Attorney General to the leadership of several Hershey School entities, concerning the latter’s compliance with the provisions of a 2013 governance-based settlement negotiated between the parties. That settlement concluded a lengthy investigation of controversial real estate transactions entered into by the charity, that had raised issues involving possible director self-interest. The attorney general’s investigation had concluded that the trustees had not breached their fiduciary duties. However, the organization agreed to a series of governance changes at that the attorney general hoped would better support the school’s charitable mission.

The Attorney General’s new letter, dated February 28, 2016, speaks to the state’s “serious concerns regarding apparent violations” of the 2013 settlement. Among the apparent violations included the summer employment of a trustee’s son by one of the trust’s investment management firms; board compensation in excess of settlement-based parameters; and the board’s failure to apply timely, best efforts to recruit new board members with needed competencies. The Attorney General also references a number of other actions which were of concern. As a result, the Attorney General seeks to: (a) remove three long-serving (e.g., ten years or more) board members; (b) implement term limits (10 years); (c) reduce board compensation to levels consistent with the 2013 settlement; and (d) have the board members personally assume the costs associated with an internal conflict of interest investigation, including the costs arising from outside counsel retention.

Obviously, there are two sides to this particular controversy. Yet, the Attorney General’s letter provides a graphic example of the interest of the state in addressing conflicts of interest and other governance issues involving nonprofit corporations, and the scope of its authority in pursuing a resolution of nonprofit board actions that the AG determines to be inconsistent with charity laws.

8. GRASSLEY’S BACK (AGAIN)

Two unrelated actions confirm the continuing and forceful interest of Senator Charles E. Grassley in the governance and operation of nonprofit organizations in general, and nonprofit health systems in particular. Senator Grassley now serves as Chairman of the Senate Judiciary Committee, and as a member of the Finance Committee. In a letter to the memberships of both the Judiciary and Finance Committees, Sen. Grassley recommends that Congress apply “vigorous oversight” to assure that nonprofit hospitals “appropriately manage their responsibilities to low-income communities...[T]hat is, after all, one of the reasons why we created the tax-exempt status for charitable institutions in the first place.” The letter summarizes Sen. Grassley’s review of the billing and collection practices of a Midwestern nonprofit, tax-exempt health system that reportedly placed “thousands of accounts in collection.” Sen. Grassley’s letter reviewed the policy changes implemented by the health system following Senate scrutiny, and commended it for the corrective action taken (which included the forgiveness of $16.9 million in debt for over 5,000 patients).

The other notable Sen. Grassley action in May was his continuing focus on the administrative and other expenses of a prominent nonprofit veterans’ charity. By letter to the charity’s chairman, he expressed concern with the charity’s claim that over 80 percent of its 2013 and 2014 expenditures were used to benefit veterans. Sen. Grassley based his concern on his review of the charity’s consolidated financial statements and Form 990 for the time period. Particular scrutiny was applied to the charity’s treatment as “program expenses” of money spent on free media and advertising; on certain types of joint educational and fundraising solicitations; to its provision and funding of long-term support programs, and to program expenditures for certain conferences, conventions and meetings. By the letter, Sen. Grassley poses a series of questions relating to program-related expenses—and requests a copy of the independent review of the charity’s spending practices, as commissioned by its board of directors.

Senator Grassley’s May actions are consistent with his historical close scrutiny of the nonprofit, tax-exempt organization sector. They come at a time of subtle yet noticeable concern about health care system tax-exempt status at both the state and federal level. As such, they are
worthy of note by whichever board committee is particularly responsible for mission maintenance matters.

9. THE EVOLVING ROLE OF THE GENERAL COUNSEL

An article in the current edition of Corporate Board Member magazine describes the evolution of the role of General Counsel’s role, from simply a technical legal advisor to becoming a core member of the senior management team and a participant in strategic decisions and actions. Authored by the estimable Ben W. Heineman, Jr. the article traces the history of this evolution, concluding that it has transformed both business and legal practices in two key ways.

First, from an internal perspective, the general counsel has replaced the senior partner of the company’s outside law firm as the primary counselor to senior management and the governing board. The general counsel’s role now typically extends beyond advising on matters of law, to addressing matters of organizational performance, ethics, governance and corporate citizenship. In that regard, the general counsel is more often perceived by corporate leadership as having a degree of stature and importance comparable to that of the chief financial officer. As a result, the expertise, quality, depth and authority of the general counsel has increased proportionately.

Second, from an external perspective, the general counsel’s role has also grown with the shift in power from outside law firms, to the internal corporate legal department. As law departments have become more sophisticated, capable and influential within the organization, they are increasingly the corporate “points of contact” on a wide variety of matters involving law, ethics, enforcement and public scrutiny.

Mr. Heineman’s perspective of the general counsel as a “Lawyer/Statesman” is widely respected, and is increasingly the standard which boards and senior management refer when crafting hierarchical responsibilities for the corporate legal department.

10. EXPANDING SCOPE OF ANTITRUST COMPLIANCE

The increasing scrutiny by the federal antitrust enforcement agencies of conduct apart from mergers and acquisitions should be closely monitored by health system audit and compliance committees. The Department of Justice in particular appears to be pursuing a more aggressive antitrust profile in health care. This includes application of the Yates Memorandum on individual accountability, and expanding the scope of its enforcement profile to encompass conduct that is perceived to violate the antitrust laws relating to price fixing, market allocation and similar kinds of activity.

Under this new enforcement approach, legitimate antitrust exposure can arise from a broad spectrum of individual and organizational conduct that has traditionally been perceived to be in the realm of corporate operations, and affect employees and others who may not regularly interact with the legal and compliance department. Examples might include managed care contracting employees, who might conceivably engage in conduct interpreted as exclusionary contracting practices that harms competition; strategic/business development employees who might conceivably engage in collaborations perceived to effect service or territorial allocation; and human resources employees who may be perceived through their communications as engaging in wage-fixing or unlawful “no-poach” agreements. There are many other examples.

The ultimate question is whether the health system’s existing corporate compliance program addresses these types of antitrust concerns. The general counsel, working in consultation with the chief compliance officer, is well suited to help the Audit & Compliance Committee evaluate whether additional internal controls, standards of conduct and education/training and monitoring mechanisms are needed to reduce organizational risk.

FOR MORE INFORMATION

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

Highlights of May’s Published Articles and Speeches/Decks

- Breaking the Health Company Compliance Program Monopoly
- Giving Boards Balance As Regulatory Demands Grow
- Emerging Issues for the Audit & Compliance Committee
- Coordinating “ERM” Reporting Through the General Counsel
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:

**THE BOARD AND “MACRA”**

It is exceedingly important for the health system board—and its key committees—to be briefed on the strategic implications of CMS’ recently released proposal to implement the physician payment reforms required under “MACRA.” Given the legal and compliance components of MACRA, the system general counsel is well-positioned to provide this briefing.

As most general counsel know, MACRA will impact how CMS pays physicians for services provided to Medicare beneficiaries by substantially linking such payments to performance metrics and incentivizing physicians to reduce hospital utilization and to participate in alternative payment models that bear substantial financial risk. MACRA will create powerful incentives that will accelerate the reshaping of the physician services market.

MACRA will likely encourage physicians to consolidate into larger groups, enter into arrangements with physician specialty management companies, or, most likely, become employed by or otherwise contractually aligned with health systems in order to have access to the IT and other care management infrastructure that they will need to achieve the MACRA metrics. Accordingly, MACRA presents a significant opportunity for health systems to create greater clinical and financial alignment with their physicians (and to manage the hospital utilization incentives described above) —as well as a greater risk of losing this opportunity to their competitors. MACRA will create further impetus for the creation of hospital and physician systems that are fully integrated, clinically, operationally and financially.

The need for board awareness lies in the profound change these reforms are expected to have on health systems, their physician relationships, strategic planning and legal compliance. MACRA will affect the roles and responsibilities of key board committees such as Strategic Planning; Audit & Compliance; Physician Compensation and Finance, to say the least. The general counsel can be a highly effective advisor to governance in all MACRA-related briefings.

**AUDIT/COMPLIANCE COMMITTEE BRIEFING**

Several important developments in June merit the attention of the system’s Audit & Finance Committee. These include new DOJ rules that would nearly double penalties under the False Claim Act, and the latest public comments on application of “Yates Memorandum” principles from senior DOJ officials.
DOJ's interim final rules (issued on June 29) substantially increase both the minimum and maximum per claim penalties. They are set to go into effect on August 1, 2016 and will apply to claims after November 2, 2015. McDermott's "white collar" attorneys expect that, among other factors, the new rules will likely not result in increases in the actual amounts paid by entities settling cases, because DOJ typically settles for a multiplier on single damages only (2-3 times absent a financial inability to pay), and foregoes penalties altogether.

However—and this is key for the Audit & Compliance Committee—the expectation is that the new rules will increase the pressure on entities, whether for-profit and not-for-profit, to settle cases because of the enormous potential exposure. Bond and other financing could be jeopardized, which may affect settlement decisions in marginal cases. Thus, the "business risk" implications of FCA penalties become potentially far more significant, which is a serious board/committee oversight consideration.

Committee members may also benefit from reading the June 9 speech of Acting Associate Attorney General Bill Baer. In his comments, Mr. Baer discussed the rationale for the government's commitment to individual accountability, and the core elements of corporate cooperation, in the context of a larger discussion on FCA enforcement.

LEVEL OF DIRECTOR ENGAGEMENT
The June 8 comments of United Airlines CEO Oscar Munoz draw meaningful attention to the critical fiduciary responsibility of "engagement" and the risks that can arise when a governing board becomes isolated from corporate operations.¹

While not capable of precise measurement, "engagement" generally refers to the broad level of commitment of the director to his/her fiduciary duties given the circumstances at hand. It extends beyond the mere calculation of hours spent by board members in the performance of governance responsibilities, to subjective factors such as attentiveness, diligence, exercise of constructive skepticism, awareness of operational results, sensitivity to trends and developments, and commitment to service (i.e., no over-boarding).

In his comments, Mr. Munoz was critical of the United board's level of engagement. Indeed, he attributed much of the operational decline of the airline in recent years to the board's isolation—reflected in part by the infrequency of its meeting schedule. This, according to Mr. Munoz, resulted in lack of operational insight and the board's inability to respond more quickly to problems, such as the company's challenging reservations system.

When scrutinizing board conduct, regulators and third-party interest groups increasingly focus on evidence reflecting the level of board engagement generally, and on particular board agenda items in particular. As health systems agendas become increasingly more complex, important third parties will likely expect a level of engagement by board members that is commensurate with that complexity. As Mr. Munoz suggested, infrequent board meetings may manifest to some a lack of necessary engagement.

TAX EXEMPTION ENFORCEMENT
The long term future of the Exempt Organizations (EO) Division of the Internal Revenue Service in terms of regulating the tax-exempt organizations sector is the subject of a June 8 report of the IRS' "Advisory Committee on Tax Exempt and Government Entities" (ACT). As such, it is worthy of notice by the Board's Mission, and Audit & Compliance committees.

ACT is an organized public forum for discussion of relevant exempt organizations; tax-exempt bonds and other tax issues. It enables the IRS to receive regular input on the development and implementation of IRS policy concerning the EO community. ACT members are selected by the IRS Commissioner and appointed by the Department of the Treasury.

The ACT report mirrors the perspective of many tax-exempt organizations that the EO enforcement and technical educations functions of the IRS have significantly declined over the past several years. As a result, the ACT report expresses concern that the IRS may be unable to regulate the EO community "consistently and effectively." Accordingly, the ACT makes a series of recommendations intended to assist the IRS in reclaiming its role "as a regulator of tax-exempt organizations" instead of what ACT described as "its nearly exclusive focus on tax administration."

¹ See also: "United CEO Says Board Was Too Isolated to See Airline's Slide," Michael Sasso, Bloomberg.com.
The ACT report can serve as a reminder to health system boards and their legal risk evaluation function that compliance with exempt organization tax laws remains important, and that there are credible public voices calling for the IRS to return to more active oversight of the exempt organization sector.

CONFLICTS OF INTEREST

The controversy surrounding the board of the Hershey Trust continues to offer a duty of loyalty tutorial of sorts for the health system board. This is particularly the case with respect to the regulatory and reputational risks that can arise from the perception (not just the reality) of conflict of interest.

As mentioned in our June Newsletter, the current controversy arose earlier this year when the Pennsylvania Attorney General expressed concern that the Hershey board had violated certain provisions of a 2013 conflicts of interest settlement. Hershey is one of the largest U.S. charitable entities, with approximately $12 billion in assets. The June issue arose from a series of published reports that in 2015, the then-Chairman of the board worked through the Trust's CEO to obtain a summer internship for the Chairman's son with one of the Trust's money management funds.

According to the media reports, it was the effort to obtain the internship (in the context of the conflicts guidelines set forth in the 2013 settlement) that prompted the Attorney General to seek the removal of three trustees (including the Chairman) and to direct the Trustees to personally reimburse the trust for the reported $650,000 cost of an internal review of the internship issue conducted by outside counsel.

[The media reports provide that while the Chairman did ultimately disclose the internship (through an email to the Vice Chairman), that disclosure occurred well after the internship was arranged, and did not make reference to the role of the Trust's CEO in helping to arrange for the internship.] While the outside counsel review concluded that the Chairman's conduct complied with the Trust's governance policies, the Trust and its board were subsequently subjected to substantial public criticism for the arrangement.

This controversy—which has yet to be brought to conclusion—helps to underscore the need for board members to try to avoid even the appearance of conflict of interest in their corporation-related relationships and arrangements. In many instances, the "perception" of conflict can be as damaging to a corporation's reputation as can be an actual conflict; and, when a corporation is already under regulatory scrutiny, "perception" can serve to "lengthen the ethical shadow" over the organization and its board.

STRATEGIC PLANNING COMMITTEE & ANTITRUST

The Department of Justice's recent antitrust initiatives in health care—outside of the "M&A" arena—continue to provide noteworthy "fodder" for Strategic Planning Committee attention. The newest initiative was its June 9 antitrust suit against Carolinas Healthcare System, alleging that CHS imposed "steering restrictions" into its commercial payor contracts, in violation of Section 1 of the Sherman Act.

The complaint alleges that the CHS steering restrictions in its payor contracts are anticompetitive, because they (1) prevent payors from offering consumers tiered-network and narrow-network health plan options that lower costs, while preserving patients’ access to "comparable or higher quality alternative healthcare providers” to CHS, and (2) weaken the competitiveness of CHS’s rival hospitals. As to the latter, DOJ alleges that because inclusion in a top tier or narrow network can lead to higher patient volume, smaller hospitals, to qualify for selection into these types of plans, those incentives – and therefore the procompetitive effects they engender – do not materialize.

This complaint is the latest DOJ antitrust effort focusing on payor-provider contracting. [In the last half-dozen years, DOJ also issued a consent decree resolving charges that alleged monopolist United Regional Health Care System imposed anti-competitive terms in payor contracts that excluded rivals from payor networks, and sued Blue Cross Blue Shield of Michigan over most favored nations clauses in its contracts with hospitals.]

Health systems (and payors) with sizable market shares need to keep DOJ’s enforcement history regarding provider-payor contracts in mind when considering negotiations over exclusivity or other restrictive provisions. This is noteworthy for board committees (e.g., Strategic Planning and Compliance) with oversight for system payor contracting practices. Rigorous internal antitrust compliance should
extend beyond the "dealmakers" contemplating mergers and strategic transactions, to include Payor Contracting, HR, Finance, Marketing, and all departments where potentially anticompetitive conduct – such as price (or wage) fixing, conspiracies not to compete or anticompetitive exclusionary practices – could materialize.

COMPETENCY-BASED GOVERNANCE

Efforts to increase the level of industry-specific competency at the health system board and committee levels receive a "boost" from the results of a new survey conducted by a global consulting firm. The survey results demonstrate the significant value attributed to aligning board member skills with long term corporate strategy.

The survey, "Building a Great Board" (from KPMG), addresses a variety of issues associated with board composition and refinement. While the benefit of competency-based boards is stressed, other key trends cited by the survey include (a) barriers that exist to adding directors with specific expertise needed by the company; (b) the benefit arising from identifying the board's future talent needs; and (c) the recognition that a board succession plan may be a worthwhile governance mechanism. The survey also notes that an active board approach to refining board composition is supported by individual director evaluations and "director refreshment" protocols.

The general counsel is well-suited to present these issues to the board (and, in particular, to its governance committee). "Competency-based governance" is certainly relevant to assuring the long-term sustainability of the corporation. From a legal perspective, however, increasing the number of board members with specific, identified areas of expertise and perspective are particularly necessary to assuring effective board oversight of operations and senior management.

GENERAL COUNSEL ETHICAL CHALLENGES

Two developments involving the roles and responsibilities of in-house counsel are useful reminders to the board on the ethical limitations imposed on such counsel. One such development involved the challenges arising from internecine controversy, while the other involved the suspension of counsel for allegedly critical remarks about board conduct.

For example, an ongoing controversy involving control of a media company highlights how in-house counsel can be buffeted by conflict between various different corporate constituents—shareholders, management and the governing board. This is not an improbable circumstance in the nonprofit health care sector, where the potential for controversy between similar constituents (substituting "sponsors" or "members" for shareholders) always exists. In such situations, the in-house counsel is guided by Rule of Professional Conduct 1.13(a)—"the organization as the client", and provide advice consistent with the best interest of the company.

The other controversy involved the decision of the Hershey Trust (there they go again) to place its deputy general counsel/compliance officer on administrative leave for authoring internal letters and memoranda that reportedly expressed concerns about board dysfunction and the expense and distraction caused by responding to internal investigations. This controversy serves as a reminder to both the board and the general counsel of the "reporting up" (and sometimes "reporting out") obligations arising under Rule of Professional Conduct 1.13(b). [Note: the exact wording of 1.13(b) may well differ from state to state.]

CLICK HERE TO ACCESS THE LEGAL ETHICS PRESENTATION OF MICHAEL PEREGRINE AND ANNE MURPHY AT AHLA’S IN-HOUSE COUNSEL PROGRAM ON JUNE 29, 2016.

DIRECTOR PROTEST RESIGNATIONS

The recent resignations by nearly half of the board of a prominent energy company provide a reminder of the circumstances and impact of "protest" resignations by board members. In this case, the directors resigned following their failure to remove the company’s CEO, whom they felt was not well-suited to lead the company’s new business strategy.

"Protest resignations" are not wholly uncommon in the nonprofit world and, particularly, in the health care sector. Resignation is a right usually provided in state corporation law and in the bylaws. Catalysts for "protest resignations" typically include disagreements with the board or senior leadership team; perceived change in organizational mission or strategy;
concerns with corporate risk profile; discomfort with board composition; and similar matters.

Recent court decisions suggest, however, that there may be particular risks associated with a director’s choice to resign during a period of corporate controversy or distress. The act of resignation itself does not carry with it some inherent breach of duty risk. Yet, a director may not be able to avoid liability exposure for actions arising from board service merely by resigning, no matter what prompted the resignation. For that reason, media coverage of “protest resignations” can serve as a useful opportunity for corporate counsel to discuss with directors the broader topic of boardroom “exit strategies.”

CHARITABLE MISSION OVERSIGHT

The board’s "mission oversight" is of growing importance, with increasing legislative, regulatory and media concerns as to whether the operation of large, financially complex health care systems can be accommodated in the nonprofit, tax-exempt entity model. For that reason, a June 9 letter from Sen. Charles Grassley to the IRS Commissioner is relevant.

Sen. Grassley has historically retained close interest in the debt collection practices of tax-exempt health systems and their compliance with the provisions of IRC Sec. 501(r). This interest has most recently been manifested in his scrutiny of Mosaic Life Care, a Missouri nonprofit hospital system that ultimately agreed to restructure what Sen. Grassley described as its “aggressive collection practices” and to forgive almost $17 million in patient debt.

What is particularly noteworthy of his letter to Commissioner Koskinen is perspective that continued, close congressional oversight of the tax-exempt hospital sector is necessary to assure that low income patients are treated fairly. Accordingly, he calls for greater IRS investigation of problematic hospital debt collection abuses and enforcement of Section 501(r) and its provisions. He also asks for an update on efforts of the IRS and HHS to collect information on how hospitals are complying with Section 501(r).

Continued board oversight is necessary to help demonstrate that both the structure of the health system and the totality of its operations support a nonprofit, charitable purpose. Because, in certain circumstances, and to certain constituencies, the operation of, and services provided by, those systems may appear imperceptible from their tax-paying for-profit counterparts.

The board may want to take two related steps: First, confirm that the general counsel has the authority and resources necessary to monitor Sec. 501(r) compliance. Second, more formally incorporate into both the strategic planning effort, and the board decision-making process, consideration of how specific strategic initiatives and particular board decisions are consistent with the charitable mission of the health system.

FOR MORE INFORMATION

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

Highlights of June’s Published Articles and Speeches/Decks

- Fifteen Years Later: The Lasting Lessons of Enron
- Managing the Antitrust Risks of Nonprofit Investor Relations
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:

THE HERSHEY GOVERNANCE SETTLEMENT

On Friday, July 29, the Pennsylvania Attorney General, the Hershey Trust Company and the Milton Hershey School, entered into a written settlement resolving an investigation conducted by the Attorney General concerning certain governance practices of the two entities. The high profile of both the parties and of the investigation, and the terms of the settlement, are worthy of health system governance committee review.

The investigation had been prompted by Attorney General concerns with Hershey compliance with a previous 2013 settlement between the parties on certain governance related issues. The key terms of the 2016 settlement reflect the particular focus of the Attorney General’s scrutiny. Those terms included ten year term limits for board members; mandatory performance evaluations; the resignations of five individual directors; required notice to the Attorney General on board nominations and a best efforts commitment to nominate candidates with appropriate education, training and experience; limits on director compensation; limits on cross-directorships with other Hershey-related entities; and clarifications to the existing Hershey conflicts of interest policy.

The settlement brings to a close what has been to date one of the most prominent governance controversies in the nonprofit sector. While the terms and conditions set forth in the settlement reflect the measures deemed necessary by the Attorney General to protect the charitable interests, they should not be viewed as per se governance "best practices." The more significant lesson to nonprofit health systems from the settlement is the extent to which state charity officials will scrutinize and investigate charitable organizations where deemed necessary to preserve charitable assets—and the financial, operational and reputational costs (to both the organization and to individual directors) arising from such scrutiny.

NEW GOVERNANCE PRINCIPLES

On July 21, a diverse consortium of prominent corporate executives and business leaders released the compilation, “Commonsense Principles of Corporate Governance.” The compilation contains a series of recommendations within nine broad categories of governance, most of which are highly relevant to health care systems (whether for-profit or nonprofit).

The stated goal of the consortium members is to offer the recommendations as a set of “Principles” on which they found common ground, in the hope that they will promote further conversation on corporate governance. The group’s
consensus reflects a shared belief that “empowered” boardmembers and shareholders contribute to long term corporate success through the provision of meaningful governance-based oversight. Indeed, the Principles draw an important connection between effective corporate governance and economic growth. As such, the Principles serve as an excellent topic for discussion by health system board governance committees, with the assistance of the system’s general counsel.

Those Principles most relevant to health system governance are those that address Board Composition, Director Responsibilities, Director Education, Committee Matters, Director Independence, Board Agenda, Director Refreshment, Succession Planning and Corporate Reputation.

Several of the Principles’ more progressive recommendations may prove controversial with some CEOs, especially those who wish to keep tight control of who has access to their boards, and to whom their boards have access. These potentially controversial Principles include those that promote (a) the use of outside advisors and experts in making board education presentations; (b) implementation of a pure, undiluted executive session practice; (c) “unfettered” board access to the entire management team; and (d) talent development practices that allow for direct board exposure to key company employees.

When advising leadership, the general counsel should be careful to describe the Principles both for what they are -- recommended, “commonsense” guidelines, and for what they are not -- absolute standards or “best practices.” The real value in the Principles is the opportunity their release offers for new, meaningful dialogue on governance matters within the board.

THE GC/CFO RELATIONSHIP

An important new article in the Harvard Business Review speaks to the critical importance that should be attributed to the General Counsel/Chief Financial Officer relationship. The article’s emphasis on a necessary “alliance” between these two key officers should be closely considered by the executive committee (if not the entire board) and by the CEO.

The article, written by the estimable Ben W. Heineman, Jr., is premised on two key developments: first, the increasingly consequential integration of the finance and legal functions of a corporation; and second, the dramatic evolution of the expertise, quality breadth, power and compensation of the GC. According to Mr. Heineman, “the optimal CFO-GC alliance is now more like a peer relationship, jointly coordinating and overseeing fundamental corporate issues of performance, compliance, ethics, risk and governance, and organization.” In addition, Mr. Heineman attributes to both officers the attribute as corporate “statespersons”, as it relates to the preservation of organizational ethics and reputation. Acting simultaneously as partners to senior corporate leadership and as guardians of the corporation, the expectation is that they will work collaboratively to preserve a “pervasive culture of integrity.” This recommended partnership is expected to contribute significantly to effective corporate action.

Particularly interesting may be Mr. Heineman’s recommendation that the GC and CFO share responsibility for designing compliance systems and processes that ensure adherence to formal legal and financial rules. Working in conjunction with compliance and risk departments, he projects the GC and CFO as working together effectively to develop robust internal procedures of process mapping, risk assessment and risk mitigation relating to rules that apply to all corporate functions.

This unique and important perspective is consistent with the emerging “best practice” that positions the general counsel as not only a legal technician, but also as a valued business partner of management and counselor on organizational ethics. It is similarly consistent with corporate responsibility principles that advocate for a GC-to-CEO (or COO) reporting relationship as opposed to a GC-to-CFO reporting relationship. Importantly, it also acknowledges the obstacles that sometimes arise between the finance and legal functions. Its call for a “strong, respectful, mutually supportive partnership” between the GC and the CFO should be closely considered by corporate governance and the CEO.
GOVERNANCE OVERSIGHT OF CYBERSECURITY

Most health system governing boards have some basic awareness of the cybersecurity issues that confront their organizations. Two recent developments serve to confirm the significance of those risks, and help to underscore the board’s critical oversight obligations in the area.

The first development is the July 18 agreement by which Oregon Health & Science University settled potential HIPAA violations through a monetary payment of $2,700,000 by OHSU to the Department of Health and Human Services. The settlement was prompted by an HHS Office of Civil Rights investigation that found widespread and diverse problems at OHSU. OCR’s investigation began after OHSU submitted multiple breach reports affecting thousands of individuals, including two reports involving unencrypted laptops and another large breach involving a stolen unencrypted thumb drive. The investigation ultimately uncovered evidence of widespread vulnerabilities within OHSU’s HIPAA compliance program. The cited problems will be addressed through a comprehensive three-year corrective action plan. Notably, in its press release announcing the settlement, OCR was highly critical of OHSU’s security management processes. “This settlement underscores the importance of leadership engagement and why it is so critical for the C-suite to take HIPAA compliance seriously.”

Of similar board oversight relevance is the August 4, 2016, settlement between Advocate Health Care Network and the OCR for multiple potential HIPAA penalties involving ePHI. Advocate will pay a settlement amount of $5.55 million and adopt a corrective action plan. According to OCR’s press release, the penalty is the largest to-date against a single entity, and reflects the extent and duration of the alleged noncompliance. As with the OHSU settlement, the OCR press release contains something of a warning from OCR Director Jocelyn Samuels: “We hope this settlement sends a strong message to covered entities that they must engage in a comprehensive risk analysis and risk management to ensure that individuals’ ePHI is secure.”

RESPONSIBLE CORPORATE OFFICER DOCTRINE

The continued willingness of federal courts to apply the harsh Responsible Corporate Officer Doctrine (RCOD) presents particular compliance—and executive retention—challenges for boards of certain types of life sciences and health care companies. A recent decision of the Eighth Circuit, upholding prison sentences for executives held to have committed misdemeanor violations of federal food and drug laws, confirms the continued viability of this enforcement theory as part of the government’s enhanced efforts to hold individuals responsible for corporate wrongdoing.

The Eighth Circuit’s July 6, 2016 opinion in U.S. v. DeCoster upheld three month prison sentences for two commercial farm executives who had pled guilty to misdemeanor violations of the Food Drug & Cosmetic Act (FDCA) for introducing into interstate commerce salmonella-tainted eggs. The executives had appealed their sentences, arguing that the RCOD is unconstitutional and that the sentences were unreasonable on procedural and substantive bases.

The Court of Appeals concluded that the defendants were not required to have known that they violated the FDCA in order to be subject to the criminal penalties, nor were they required to have actual knowledge of the wrongful conduct [emphasis added]. The inference (supported more clearly by the Concurring Opinion) was that the defendants’ responsibility was grounded in negligence—their failure to exercise sufficient care to prevent the introduction of the spoiled eggs into commerce.

Harsh enforcement theories such as RCOD [and certain elements of and OIG’s permissive exclusion authority] reflect extreme extensions of the current federal focus on individual accountability for corporate wrongdoing. As such, they present unique governance and executive retention challenges to the boards of life sciences and health care companies. These challenges may be met, in part, in two ways: first, by enhancing the efforts of senior executives to support compliance measures (helping to rebut suggestions that executives were negligent in their supervision of the organization and its commitment to legal and regulatory compliance); and second, by increasing personal liability protections available to those executives.
CEO SERVICE ON OUTSIDE BOARDS

Newly revised policies adopted by the University of California Board of Regents provide an opportunity for health system boards to revisit the protocols they apply to review the appropriateness of outside business interests—including but not limited to outside board service—of senior executives. These types of protocols are typically premised on the core assumption that many such outside interests bring value to the organization and are to be encouraged.

The emphasis of the new UC policy revisions are threefold: First, to reinforce the existing requirement that senior executive members must obtain approval for all outside activities, whether compensated or uncompensated, before they may engage in the activity or announce participation in the activity; Second, to strengthen the authorization process by adding an additional level of approval to the process by which an executive’s request to participate in the outside activity may be authorized (i.e., so that the executive’s request would be reviewed and signed off on by both his/her manager and by the next higher level manager as well); and Third, in addition to completing currently required disclosure forms, senior executives would be required to submit a statement describing the benefits that accrue to the University for any proposed outside activity.

As the UC policy notes, such outside service often inures to the overall benefit of the organization. Indeed, by the nature of their experience and perspectives, health system senior executives are frequently in demand, for various appropriate reasons, by outside business and charitable organizations as board members, consultants or advisors. However, such outside service can, in certain circumstances, present issues relating to conflicts of interest, conflicts of commitment and tax/compensation and benefits issues. For that reason, sophisticated internal policies, such as the revised UC policy, can be helpful in balancing the value of such outside service, with the legal and reputational issues that may potentially arise therefrom. As such it may be an appropriate agenda item for a future governance or executive compensation committee meeting.

INTERLOCKING DIRECTORSHIPS/ANTITRUST RISKS

On July 14, The Department of Justice announced that two providers of electronic brokerage services restructured their $1.5 billion transaction after the Department expressed Clayton Act Section 8 concerns. This underscores the antitrust risks arising from interlocking boards between corporations that could reasonably be considered as competitors. Section 8 compliance is an increasing legal feasibility issue with certain types of governance arrangements arising in the rapidly consolidated health care industry.

In general, Section 8 of the Clayton Act prohibits a person from serving as a director or board-elected or board-appointed officer of two competing corporations whose profits and amount of competing revenues exceed inflation-adjusted statutory thresholds. The primary purpose of Section 8 is to prevent harm to competition by removing the opportunity or temptation to violate the antitrust laws through the interlock. Private parties may bring an action to enforce Section 8. The principle remedy for a violation of Section 8 is removal of the interlocking directors or officers (injunctive relief). As originally structured, the transaction that was the subject of the Department’s July 14 announcement would have created an interlocking governance arrangement between two competitors, where one organization had the authority to nominate one member of the other organization’s governing board. The transaction was ultimately restricted to eliminate the director nomination right (and a related 20 percent ownership interest by one organization in the other).

This announcement demonstrates DOJ’s interest in enforcing Section 8 where necessary to prevent “a cozy relationship amongst competitors.” Of course, the application of Section 8 depends upon the facts and circumstances of particular arrangements and the extent to which they meet certain statutory thresholds. This is particularly the case as concepts of what constitutes “competition” may evolve, given the increasing scope of operations of many health systems, and the growing diversity of their business operations. The general counsel may wish to use this new DOJ action to remind her colleagues who structure business transactions and governance relationships between corporations (that could plausibly be considered to compete with each other) to pro-actively consider the potential Section 8 implications of those proposed transactions and relationships.
DEREK JETER AND FIDUCIARY BREACH

A recent decision of the Delaware Chancery Court involving Derek Jeter provides a topical opportunity to remind governing board members that fiduciary duty challenges can ensnare even the most legendary and respected public figures. By the decision, the Court required Mr. Jeter to defend himself against allegations that he breached certain fiduciary duties to an underwear manufacturer for which he served as a board member.

The case arose from an unusual arrangement whereby Mr. Jeter agreed to join the manufacturer’s board as part of a “reverse endorsement” strategy, whereby Mr. Jeter’s board membership and minority ownership interest would hopefully serve as an endorsement of the manufacturer’s product. Mr. Jeter entered into a director’s agreement that served to create a fiduciary relationship with the manufacturer and required Mr. Jeter to perform certain requirements (including making a public announcement about his role with the company). Mr. Jeter had initiated the litigation, seeking a declaration that he had satisfied his obligations under the agreement. The manufacturer counterclaimed, alleging, among other claims, that Mr. Jeter violated his fiduciary duty by making false statements to investors in bad faith while serving on the manufacturer’s board.

As Vice Chancellor Glasscock noted in the introduction to his opinion, “This case provides a cautionary tale of the mixing of roles in a corporate governance setting.” In Mr. Jeter’s circumstance, the mixing of roles involved the confusion between the goals and expectations under the reverse marketing arrangement, and the fiduciary obligations he assumed as a director and under the director’s agreement. Evolving governance arrangements in the health care industry offer the potential for a similar mixing of governance roles. This could arise, for example, with non-traditional arrangements involving so-called “celebrity directors”; exceptionally important donors; “fly-in directors”; certain types of constituent directorships and similar situations, where there is lack of clarity on the nature of the director’s board service and fiduciary relationship to the health system. The case also offers a useful example on the types of actions and nonactions that could give rise to a breach of loyalty claim.

COMPLIANCE EDUCATION GAPS

A new survey of almost 650 ethics and compliance professionals found significant gaps in training topics offered to boards, when compared to training programs on similar topics provided to employees. The results suggest the need for substantially increased board education on a diverse assortment of risks, including those associated with cybersecurity, workplace harassment and conflicts of interest.

The survey, conducted by the prominent compliance software services company Navex Global, found that for cybersecurity, 13 percent of surveyed organizations offer training for their boardmembers, while 69 percent of their employees receive such training. For conflicts of interest, 19 percent of surveyed companies provide board member training while 76 percent of their employees receive such training. For workplace harassment, the “split” is even more pronounced, with only 7 percent of surveyed companies providing board member training while 76 percent of their employees receive such training. In addition, of the 58 percent of surveyed companies that report training board members on risk matters, only 20 percent offer such training in new director orientation processes. On a more positive measure, 70 percent of the surveyed organizations identified ‘creation of a culture of ethics and respect’ as the most important goal of ethics and compliance training.

These survey results are potentially significant in at least four respects. First, the new “Commonsense Governance Principles” (see above) strongly recommend robust board education programs. Second, allegations of workplace harassment within prominent corporations have been quite in the news of late. Third, conflicts of interest issues go to the director’s core duty of loyalty, and there may well be need for education on the application of that duty and of the organization’s conflicts policies. Fourth, the effectiveness of board education programs generally, and ethics and compliance training in particular, should be a shared focus of the governance/board development and audit/compliance committees. Finally, the board’s willingness to receive additional education on these and similar issues may be perceived as evidence of their good faith, and of the proper “tone at the top.” The general counsel may wish to “team” with the chief compliance officer in sharing these survey reports with the proper board committees.
GENERAL COUNSEL CONFLICTS OF INTEREST

According to *The Wall Street Journal*, the chief legal officer of a major banking institution was recently ‘separated’ from the institution for what was described by the institution as a conflict of interest arising from a personal matter. This development focuses attention on the extent to which corporate conflicts policies should, and do, apply to in-house legal counsel.

The banking institution made no additional elaboration on the reasons for the separation nor on the nature of the conflict. It did acknowledge that the separation had nothing to do with the former CLO’s legal work, and described the former CLO as “a very qualified lawyer.”

Most large health systems have detailed board level conflicts of interest policies and procedures, including extensive conflicts disclosure policies and related procedures designed to support board members in the identification and disclosure of potential conflicts. Most such policies have specific procedures by which disclosed board member conflicts are evaluated to determine whether an actual conflict exists and, if so, what remedy should be applied. Fewer health systems have elaborate policies addressing conflicts of interest issues of executive officers, even though in many states those officers may be bound by the same duty of loyalty as are board members. However, some systems are moving toward more detailed review of the outside business interests of their executives [see above].

It would be inappropriate to speculate on the nature of the former CLO’s alleged conflict and on why the institution felt that separation was necessary. However, this situation may help health system general counsel and their executive colleagues to be more pro-active in evaluating the sufficiency of existing COI procedures and conduct codes affecting senior executive officers. It may also increase consideration of periodic consultation by CLO/GC with outside professional ethics counsel on matters that relate to professional duties and responsibilities, and compliance with internal corporate policies.
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:

**BUSINESS ROUNDTABLE GOVERNANCE GUIDELINES**

In an important governance development on August 3, the influential Business Roundtable (BRT) released a 2016 edition of its well-known “Governance Principles” monograph. This new release is a comprehensive revision of the 2012 edition of the Principles, and should attract close attention from corporate directors and their advisors.

The 2016 edition of the BRT Principles offers a comprehensive treatment of key principles of governance, and also fundamental governance issues such as board responsibilities, roles of key corporate actors, committee responsibilities and other, elemental governance concerns historically treated by the organization. These include board composition, director responsibilities, shareholder rights, public reporting, board leadership, management succession planning and compensation of management.

What may be particularly persuasive to health system leaders is that the Business Roundtable is an association of business executives, and that the Governance Principles reflect those issues and trends its CEO members perceive as influencing governance today.

The board should consider the new BRT Principles together with the similarly new “Commonsense Principles of Corporate Governance” released on July 25 by the Buffett/Dimon consortium of executives.

*On its own, the release of either of these two commentaries would have been a significant event, and worthy of governance committee attention. For two sets of substantial commentaries to be released in close proximity to one another is particularly consequential—and a primary reason for the general counsel to bring them to the governance committee’s attention.*

**SPECIAL FOCUS ON DIVERSITY**

One of the most prominent and publicized themes of the Business Roundtable’s new governance guidelines (see above) is its significant emphasis on diversity in the board nominating process. This will add to the pressure on health system boards to increase their commitment to diversity in governance.

*BRT’s perspective* that more diverse boards—including directors who represent the broad range of society—will strengthen board performance and contribute to the fundamental goal of creating long term value. To that end, BRT recommends that boards “develop a framework for identifying appropriately
diverse candidates that allows the nominating/governance committee to consider women, minorities and others with diverse backgrounds as candidates for each open board seat."

In this regard, the BRT Principles take the diversity commitment to a degree beyond those of many other governance compilations, and track recent related comments of SEC Chairperson Mary Jo White. The BRT Principles do not “take sides” in the external debate on whether increased racial and gender diversity correlates to improved corporate financial performance. Rather, they support the broader concept that corporate decision-making, and talent acquisition, benefits from an environment that is supportive of diversity in backgrounds and perspectives.

NEW JUDICIAL EVALUATION OF “CAREMARK” STANDARD

A new Delaware Chancery Court decision provides additional clarity on the burdens associated with substantiating a claim of breach of fiduciary duty for compliance program oversight (the so-called “Caremark” duty). The case also allows general counsel to address with key board committees how this duty may be (differently) evaluated in the context of a governmental enforcement action.

The case—a shareholder derivative action—was based upon allegations that the company’s board was aware of several company violations of antitrust laws yet failed to take pro-active steps to improve antitrust compliance. The court reiterated that evidence of “bad faith” (i.e., “conscious disregard”) was necessary to establish the elements of a Caremark claim. According to the chancery court’s definition, incorrect exercise of business judgment in response to compliance “red flags” is insufficient to constitute bad faith.

It has been often noted by courts that Caremark claims are among the most difficult corporate litigation claims to be instituted against board members. However, it should be noted that there are no leading state or federal decisions that conclusively apply the Caremark “bad faith” standard to nonprofit boards. Further, it is uncertain that the Department of Justice, the Office of Inspector General and other regulatory agencies would feel limited by the Caremark standard in evaluating the effectiveness of corporation’s compliance plan (and the board’s oversight role thereof) in the context of a governmental investigation. The health system general counsel is well suited to place Caremark-related judicial decisions in the proper context for the governing board.

INTERMEDIATE SANCTIONS ANNIVERSARY

July 30 marked the 20th anniversary of the enactment of the Intermediate Sanctions provisions of the Internal Revenue Code (Section 4958). This anniversary provides the nonprofit health system general counsel with a unique opportunity to remind senior leadership of the provision’s continuing relevance—and enforcement risks as well as review the current procedures in place to protect against Intermediate Sanctions to make certain such procedures are best practice.

The purpose of the new provision was to provide the Internal Revenue Service (IRS) with an alternative enforcement option (i.e., other than revocation) to incidents of private inurement or other forms of “excess benefit” arrangements that do not call into question the continued tax-exempt status of the nonprofit entity. As most general counsel are aware, Section 4958 authorizes the Service to impose penalty excise taxes on “excess benefit transactions” between “disqualified persons” and their respective Section 501(c)(3) or 501(c)(4) organization. While the organization itself is not subject to penalty, organizational managers (including, board members, officers and persons having similar powers or responsibilities to board members and officers) may be subject to personal excise tax penalties.

Section 4958 is a highly complex statute not only with respect to determining what constitutes an excess benefit transaction and the circumstances under which excise tax penalty exposure is created, but also the circumstances under which the “Rebuttable Presumption of Reasonableness,” which presumption provides meaningful protection against the imposition of Intermediate Sanctions (and, more generally, helps demonstrate that the board member or officer is adhering to their fiduciary duties), are satisfied. Unlike other some other state and regulatory agencies, the IRS does not generally publicize incidents of Section 4958 enforcement. Nonetheless, violations of the Intermediate Sanctions rules must be self-reported by the organization on its annual Form 990, which filing is a publicly available document. For these and other reasons, the “Anniversary” may provide a welcome opening for the general counsel to review with key board committees the law’s application to non-profit health system leaders.

“D&O”/ADVANCEMENT/INDEMNITY ISSUES

Given the current regulatory enforcement environment, an increasingly important responsibility of the general counsel is to advise the corporation, and its officers and directors, on the
application and extent of insurance/advancement and indemnification protections. Several new cases demonstrate how important this responsibility can be.

For example, an August 4 decision of a federal district court in Colorado concluded that a company’s then-existing D&O policy did not provide coverage for the costs incurred by the company in responding to an SEC investigation. Based upon the nature of the SEC inquiry, the court determined that it did not reflect the allegation of a “Wrongful Act” by the company as required in order to constitute a “Claim” under the policy. Rather, the court interpreted that it was an investigation to determine whether the company had indeed violated the law.

In an unrelated Delaware decision, litigation expense advancement was denied to a corporate vice president. The court ruled, based on applicable state law, that an employee becomes a corporate officer (and entitled to advancement benefits) only as provided by the corporation’s bylaws. In this instance, the bylaws provided that officers must be elected by the board (and vice presidents were not so elected).

These and similar decisions may prompt the health system general counsel to review with organizational leadership the extent of current insurance and indemnification rights, and identify areas for possible enhancement. Such efforts may be particularly useful given the “gatekeeper anxiety” arising from the Yates Memorandum.

THE COO AND THE GC’S REPORTING RELATIONSHIPS
An August 24 article in The Wall Street Journal addresses what is described as a trend with leading corporations to eliminate the chief operating officer position, in order to “flatten” management structures. To the extent the chief financial officer assumes the COO duties—as is suggested by The Journal—it could complicate the general counsel’s reporting relationships.

In many large organizations, including organizationally complex health systems, the general counsel directly reports to the COO. This reporting relationship is consistent with corporate responsibility principles, when the COO carries out the day-to-day duties of the CEO and the general counsel has futility bypass rights to the CEO and to the board, respectively. However, such principles generally discourage a “general counsel-to-CFO reporting relationship,” for many reasons (e.g., their respective roles in financial reporting and disclosure; the CFO’s role in transaction development and budget development, etc.).

Thus, the CFO becoming the general counsel’s “direct report” may create a corporate responsibility dilemma. Indeed, enforcement agencies are increasingly evaluating reporting relationships for indicia of organizational commitment to legal compliance. Thus, the potential conflicts and tensions arising from such a shift should be closely considered by senior management, and protections built into the new relationship.

SEVERANCE AGREEMENT CHALLENGES
The health system general counsel may wish to take note of recent SEC enforcement actions with respect to severance agreements that were interpreted by the Commission as limiting the ability of outgoing employees to file applications for SEC whistleblower awards. The general counsel may wish to coordinate her response with the SVP/Human Resources, and with the Chief Compliance Officer.

In orders announced August 10 and August 16, respectively, the SEC announced that two separate companies had agreed to pay monetary penalties and to implement other remedial action for (allegedly) illegally using severance agreements as a means of placing barriers to accessing the SEC’s whistleblower program. In one order, the cited conduct was a waiver and release of claims that was interpreted by the SEC as prohibiting the outgoing employee from filing an application for, or accepting, a whistleblower award from the SEC. In the second order, the cited conduct was a confidentiality provision in the severance agreement that (allegedly) prohibited the ability of the outgoing employee from sharing with anyone (presumably including the SEC) confidential information the outgoing employee had learned about the company during the period of employment.

This enforcement action is relevant to both publicly traded and nonprofit health systems. Whistleblower activity is generally considered to be an important element of an organization’s overall compliance program. The general counsel may wish to coordinate with HR and compliance colleagues to make sure that severance agreements achieve their intended goals without placing problematic barriers on certain types of protected whistleblower activity.

CONFLICTS OF INTEREST DEVELOPMENTS
A series of recent developments combine to reflect closer scrutiny of relationships and other arrangements that raise conflict of interest issues at the director and officer level. In so doing they serve as a
“prompt” to review the effectiveness of existing health system conflicts disclosure and review processes.

The most significant of these developments was the August 21 feature story in *The Wall Street Journal*, “Nonprofit Hospitals’ Business Relationships Can Present Conflicts.” The article focused on business relations between the hospital, its executives and its board members, drawing from information available in the Form 990. The article focused on the frequency by which hospitals and health systems conduct business with their board members and the substantial dollar amounts allegedly involved in those arrangements.

To this point, the article profiled three separate business transactions involving a health system and corporate “insiders” (or their family members). While the article contained the normal caveat about the mere existence of a conflict not necessarily suggestive of legal concerns, the inference in each case was that a presumption of bias existed.

This article and other new developments serve as a strong reminder for health systems to review the sufficiency of their policies with respect to the disclosure and determination of conflicts; the outside business activities of executives and board members; and the reputational and other issues associated with arrangements that create the “perception” of a conflict of interest.

DEFINING “CHIEF LEGAL OFFICER”

A new article in *Corporate Counsel* speaks to the growing use of the term “Chief Legal Officer” by large organizations to denote the senior legal officer, and to reflect the role of that officer as a “business partner” with the members of the executive leadership team. The article reflected the perspectives of several legal search professionals.

The concept of the “CLO” is relatively new and, as a result, it does not appear to carry with it any broadly accepted definition. Experience suggests that the title is used to bestow greater authority and greater organizational prominence.

To date, the title “CLO” seems most often used with companies that are multi-jurisdictional and/or multi-departmental in scope, with many subsidiaries and perhaps several regional or business division general counsel. It is a position that essentially is intended in some circumstances to incorporate those additional duties of business strategy partner and ethics counselor that knowledgeable observers now attribute to the modern general counsel.

To avoid confusion, it is important that one officer—be it the CLO or the GC—is designated as the head of the corporate legal department and is thus responsible for the legal affairs of the entire corporation. To the extent that the CLO participates in substantial business and strategy discussions, clarity should be added to what portion of her advice is subject to the attorney-client privilege.

**BRIEFING GOVERNANCE ON TRANSITION TO APMs**

Health system general counsel can play an important role in encouraging appropriate board and committee level briefings on the organizational implications of MACRA and other “transformational” alternative payment models. The most recent governance principles commentaries underscore the importance of focused board education on developments of strategic importance.

Certainly, payment reform stands out in terms of its broad-based impact on health care systems. The need for board awareness lies in the profound change MACRA and other APMs are expected to have on health systems: e.g., their physician relationships, strategic planning; mergers/acquisitions; capital budgeting and debt financing; information technology; human resources/employee benefits; quality of care and legal compliance. This suggests the need for a core level of full board training and education, with more focused training provided for individual committees whose charter responsibilities are implicated by the expected developments.

The general counsel is uniquely positioned to support this educational commitment, given the fundamental legal and regulatory implications of the payment reform; the general counsel’s role as a primary advisor to the governance committee, and the general counsel’s overall prominence within the organization.

**FOR MORE INFORMATION**

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**Highlights of August’s Published Articles & Speeches**

- The General Counsel’s New Opening to the Governance Committee
- Return of Exec Accountability Creates Compliance Challenges
- A United Effort to Overhaul Corporate Governance
Commonsense Governance Principles: Returning Governance to its “Commonsense” Roots

Posted by Michael W. Peregrine, McDermott Will & Emery LLP, on Wednesday, July 27, 2016

Editor’s note: Michael W. Peregrine is a partner at McDermott Will & Emery LLP. This post is based on an article by Mr. Peregrine; his views do not necessarily reflect the views of McDermott Will & Emery or its clients. The Commonsense Governance Principles are available [here](#).

The new “Commonsense Principles of Corporate Governance” (“the Principles”) are a welcome and thoughtful contribution to corporate governance discourse.

Released on July 21, the Principles consist of a series of “commonsense” recommendations and guidelines concerning the roles and responsibilities of boards, companies and shareholders. They are intended to provide a basic framework for sound, long-term-oriented governance and, as such, are responsive to a growing desire across commercial interests for greater clarity in leading boardroom challenges.

The Principles were prepared by a diverse, twelve-member coalition of executives of major corporations (e.g., JP Morgan, Berkshire Hathaway, GE, GM and Verizon); asset managers (e.g., BlackRock, Vanguard Group and State Street); and one shareholder activist (ValueAct Capital Management). As the mix of coalition members suggests, the Principles reflect a consensus on basic governance guidelines that “are conducive to good corporate governance, healthy public companies and the continued strength of our public markets.”

This consensus is grounded in a shared belief amongst the coalition members that “empowered” board members and shareholders contribute to long term corporate success through the provision of “meaningful oversight.” Indeed, the Principles draw an important connection between effective corporate governance and economic prosperity. In that regard, they project frustration with the recent, antagonistic level of governance dialogue amongst investors, corporate leaders and other stakeholders.

These Principles address a number of elemental governance topics, including board composition; director responsibilities; shareholder rights; public reporting; board leadership; management succession planning; and compensation of management. They emphasize critical issues of director engagement; independence, accountability and refreshment and support a governance structure that is oriented towards the long term. Among the Principles, highlights include:
- **Board Composition:**
  A significant emphasis on integrity, appropriate levels of competency and experience; boardroom atmosphere (collegiality amongst board members but the exercise of constructive skepticism); director engagement (the need to commit substantial time and energy); and periodic rotation of leadership positions;

- **Director Compensation:**
  A commitment to fair compensation, with addition compensation for the lead independent director and committee chairs; incorporating a substantial equity payment component to director compensation; the possibility that compensation for committee service may vary (e.g., according the scope of the committee’s duties); and periodic rotation of leadership positions;

- **Director Education:**
  A surprising degree of support for new director onboarding initiatives and for continuous director education on industry developments;

- **Committee Matters:**
  A welcomed focus on the well-developed committee structure and responsibilities; disclosure to shareholders of committee structure and function;

- **Board Agenda:**
  Setting the board agenda to focus on "big picture issues"; emphasizing delegation to management where appropriate and reducing board time spent on "frivolous or non-essential matters"—ten specific areas for agenda focus are recommended;

- **Director Refreshment:**
  Balancing the need for "fresh thinking and new perspectives" with the benefits of age and experience; no recommendation is made with respect to tenure and mandatory retirement but rather a call for companies to "clearly articulate their approach" on those sensitive topics;

- **Shareholder Rights:**
  Challenging the concept of dual class voting ("is not a best practice");

- **Public Reporting:**
  Required quarterly reporting should be framed "in the broader context" of corporate strategy with an outlook on progress (or lack thereof) towards long term goals; no obligation to provide earnings guidance; provide explanations of when and why material M&A transactions and capital commitments are being undertaken;

- **Independent Leadership:**
  The decision on whether to separate the CEO and Chair roles should be made by the independent directors; a detailed framework for the role of the lead independent director is offered;

- **Reputation:**
  An acknowledgment that protecting the corporate reputation and strengthening corporate culture are board responsibilities;

- **Role of Asset Managers:**
  Active and balanced (to understand the company’s perspective) engagement between asset managers and company management.

Several of the Principles’ more progressive recommendations may be controversial with some CEOs; e.g., the use of outside advisors and experts in making board education presentations; a pure, undiluted executive session practice; "unfettered" board access to the entire management team; and talent development practices that allow for direct board exposure to key company
employees. The Principles also encourage the board to act promptly to address situations where the company does not have "the appropriate CEO" (suggesting a much broader evaluation perspective than non-performance).

Moreover, the Principles contribute to the ongoing discourse on diversity standards for governance by correlating "diversity along multiple dimensions" with effective governance, and by recommending that director candidates be drawn "from a rigorously diverse pool."

It will always be difficult to condense a topic as broad as governance principles into a format that will facilitate reading and comprehension. That being said, the Principles reflect some "missed opportunities"; important governance topics that arguably deserved note. These include only a limited reference to the critical nature of the board's enterprise risk management responsibilities; no material reference to its compliance oversight duties; and no acknowledgment of the movement towards assuring the general counsel a prominent position within the senior leadership team; the oft-referenced role of the general counsel as "lawyer-statesman." Also notable is a generic reference to addressing "material corporate responsibility matters" without any explanation of the term.

There is no suggestion that the Principles are intended to be a "one size fits all approach," or absolute. The coalition members recognize that "not every principle (or every part of every principle) will work for every company, and not every principle will be applied in the same fashion by all companies." Rather, they project a hope of prompting continuing, respectful dialogue on governance matters amongst key corporate constituents.

And that dialogue that should include leaders of large nonprofit corporations and private companies, for a substantial number of the Principles have applicability across all types of legal entities. In this respect, the Principles seem less focused on establishing "best practices" per se, and more on offering a consensus perspective on how "good governance" works in the real world.

The Principles are directly responsive to a growing call from the boardroom for practical guidelines on governance matters; to the desire of corporate leadership who actively seek guidance on leading practices. They are not, as some academics suggest, "mere platitudes." Indeed, the Principles arguably represent the most significant discussion of the roles and responsibilities of boards, companies and shareholders since the 2012 release of Governance Principles by The Business Roundtable (discussed on the Forum here).

For these and other reasons, the Principles should be a discussion topic at the next Board Governance Committee meeting of companies large and small, publicly traded or nonprofit.
Thoughts on the Business Roundtable’s Principles of Corporate Governance

Posted by Michael W. Peregrine, McDermott Will & Emery LLP, on Thursday, September 8, 2016

Editor’s note: Michael W. Peregrine is a partner at McDermott Will & Emery LLP. This post is based on an article by Mr. Peregrine; his views do not necessarily reflect the views of McDermott Will & Emery or its clients.

In an important governance development, on August 3 the influential Business Roundtable (“BRT”) released a 2016 edition of its well-known “Governance Principles” monograph. The new BRT Principles follows closely on the heels of the July 21 release of the “Commonsense Principles of Corporate Governance” (“the Commonsense Principles”), by a diverse, twelve-member coalition of executives of major corporations, asset managers and one shareholder activist. The 2016 edition of the BRT Principles is an important contribution to governance discourse and, together with the Commonsense Principles, is valuable fodder for consideration by the board’s governance committee.

Business Roundtable is an association of chief executive officers of leading U.S. companies, the purpose of which is "to promote sound public policy and a thriving U.S. economy". Its fundamental business model is "to apply the capabilities of its chief executive officer members to addressing (through research and advocacy) major economic and competition issues facing the nation. BRT has long maintained a close interest in corporate governance, and the August release is the latest in a series of editions of the Governance Principles (most recently, in 2012).

The Commonsense Principles are essentially a “one off,” concise articulation of 8 basic recommendations and guidelines concerning the roles and responsibilities of boards, companies and shareholders. In contrast, the BRT Principles are a more comprehensive treatment of key principles of governance, and also fundamental governance issues such as board responsibilities, roles of key corporate actors, committee responsibilities and other, elemental, governance concerns historically treated by the organization. These include board composition, director responsibilities, shareholder rights, public reporting, board leadership, management succession planning, and compensation of management. Many of these topics are also addressed by the Commonsense Principles, but not to the extent as in the BRT Principles.

It is that level of detail that has made the BRT Principles a valuable resource for officers, directors and counsel of public, private and nonprofit corporations over the years. Thus, a comprehensive revision of the BRT Principles—as the 2016 version is—should attract close attention from corporate directors and their advisors.

The 2016 edition of the BRT Principles reflects those issues and trends its CEO members perceive as driving governance today. Key among those is an increasingly complex external
environment for public companies, including the imposition of greater regulatory burdens on companies that have added cost and complexity to corporate operations. Another is the change in the level of shareholder engagement, manifest not only by the proactive engagement of companies, and higher expectations of shareholders. The following governance themes are thus emphasized:

Long Term Value Sustainability. One of the most prominent themes expressed throughout the 2016 Principles is the board's role in adopting strategies and taking other actions intended to build sustainable long term value. This theme of long term value creation is directly incorporated into five of the eight “Guiding Principles of Corporate Governance”, which is the featured element of the Principles. These include Guiding Principles addressing the board's role in oversight of management, strategic planning, executive compensation, shareholder engagement and engagement with corporate constituents. References to long term value creation also appear throughout the main body of the Principles, in sections dealing with major corporate actors, board composition, committee roles and succession planning (among others).

Shareholder Engagement. Consistent with the focus on long term value is a unique emphasis on shareholder engagement. The BRT Principles reflect the view that shareholder responsibility includes not only transparency (i.e., the nature of its identity and ownership) but also some accountability for long term value creation for all shareholders. In other words, shareholder empowerment carries with it an obligation to be responsive to the needs of long term shareholders. Along the same lines, the BRT Principles caution against shareholders using their investments in U.S. public companies for inappropriate purposes (e.g., the advancement of personal or social agendas unrelated and/or immaterial to the strategy of the company). The expectation is that matters of shareholder responsibility and accountability will become a leading aspect of governance discourse for the coming years.

Board Diversity. A notable and leading theme of the BRT Principles is an enhanced focus on diversity in the board nomination process. This reflects BRT's perspective that more diverse boards—including directors who represent the broad range of society—will strengthen board performance and contribute to the fundamental goal of creating long term shareholder value. To that end, BRT recommends that boards "develop a framework for identifying appropriately diverse candidates that allows the nominating/governance committee to consider women, minorities and others with diverse backgrounds as candidates for each open board seat."

It is a theme which has been particularly emphasized by BRT in its external promotion of the Principles. In this regard, the BRT Principles take the diversity commitment to a degree beyond those of many other governance compilations, and track recent related comments of SEC Chairperson Mary Jo White. The BRT Principles do not “take sides” in the external debate on whether increased racial and gender diversity correlates to improved corporate financial performance. Rather, they support the broader concept that corporate decision-making, and talent acquisition, benefits from an environment that is supportive of diversity in backgrounds and perspectives.

Sustainability. The BRT Principles also acknowledge the growing emphasis on sustainability; i.e., the expectation that “good corporate citizenship” includes conducting corporate operations “with meaningful regard for environmental, health, safety and other sustainability issues relevant to its operations.” The board is thus expected to be attentive to developments relating to
economic, social and environmental sustainability issues, and to acknowledge the relationship of such issues to the company’s business, the shareholders’ interests and the board’s overall agenda. BRT’s emphasis of citizenship and sustainability considerations may serve as a “prompt” to those boards heretofore reluctant to fully embrace those concepts as part of their agenda.

**Committee Practices.** Several noteworthy comments are offered on the committee practices of corporate boards. There is a specific suggestion to consider limiting the service of audit committee members on other public company audit committees, given the significant responsibilities associated with such service. This is consistent with several general references to concerns with director/committee member refreshment.

In addition, the governance and nominating committee is encouraged to annually review the composition of the full board (including an assessment of the mix of director skillsets and experience); an evaluation of whether the board “has the necessary tools to effectively perform its oversight function in a productive, collegial fashion;” and the identification of the qualifications and expertise that the board may need in the future. Not surprisingly, the compensation committee is encouraged not only to assure alignment of interests of executive leadership, the company and the shareholders, but also to foster long term corporate value creation.

Related to the nomination process is a recommendation that, given the risk of conflict of interest, directors and director nominees not be a party to any compensation-related agreement with any third party that relates to their board service or director candidacy with the company (except for traditional expense reimbursement arrangements relating to director candidacy).

**Succession Matters.** The BRT Principles include a strong emphasis on CEO and senior management succession planning, for both traditional and emergency circumstances. The board is also encouraged to support talent development practices for management team members below the most senior ranks, in order to “build a bench of future candidates for senior management roles.”

The BRT Principles are characterized as representing “current practical and effective corporate practice” (i.e., not quite reaching “best practices” level as the concept is strictly defined.) As with the Commonsense Principles, there is no suggestion that the BRT Principles are intended to be a “one size fits all approach,” or absolute. Rather, the BRT Principles are intended to be used as a guide in developing the structures, practices and processes that are “appropriate” given the unique perspectives of individual corporations.

Yet the BRT Principles are also noteworthy for what they do not say—or at least, what they no longer emphasize. In order to update the Guidelines and place the proper emphasis on the new themes (above), many provisions from the 2012 edition appear to have been streamlined or reduced in content. This includes many of the provisions which dealt with important considerations of ethics, compliance and corporate responsibility.

While there is no suggestion that this streamlining reflects an intentional effort to reduce emphasis on those critical considerations, some readers may nevertheless infer as such. Other, more mischievous readers may take it to the next level: arguing that this streamlining indeed was intentional; an effort by the BRT to “tone down” the level of board and management focus on legal compliance matters. That would be an unfortunate interpretation, as it is unlikely the drafters'
actual intent. (Note that the Commonsense Principles were similarly "light" on legal compliance and corporate responsibility themes).

The release of the BRT Principles is a noteworthy event for boards, their governance committees and their advisors. When viewed together with the Commonsense Principles, it can be seen as a particularly consequential development. The governance committee should "take the lead" in providing analysis; for it is typically charged with monitoring governance trends and best practices, and recommending changes to board governance structures and practices as appropriate.

With respect to each of these new commentaries, governance committees should be asking: "What prompted their release?"; "What's new and different?"; "What's relevant to this board?" and "What options are available to implement key recommendations?"

The general counsel, in her roles as technical legal expert and as board adviser, is well positioned to digest the commentaries and advise the governance committee on their relevance to the board. After all, both sets of principles reflect basic concerns with shareholder dialogue and engagement, and both are grounded in corporate law and concepts of corporate responsibility. In this regard, the general counsel may wish to "team" with the board's other valued advisers in presenting a coordinated educational approach.

But whatever the presentation and whatever the style, the board and more particularly the governance committee, should understand the "who, what and why" of this "Governance Principles Summer."