THE RETURN OF VOLATILITY

Directors will (perhaps unexpectedly) be expected to confront the strategic implications of economic, regulatory and legislative volatility, much as they were required to do in 2017.

This uncertainty extends beyond the fluidity associated with the Affordable Care Act following the recent US district court decision. It also reaches such key issues as the potential for additional business disruption, the impact of value-based care and the possible amendment of the Stark Law. It also extends more broadly to the effects on the health system of divided government, economic growth, trade conflict, significant market fluctuation, the inflation rate, immigration policy and more. Addressing these factors will require special board commitment and close coordination with management.

The necessary level of engagement can be manifested in several ways, the most obvious of which is increasing the amount of time devoted to the board agenda. A second, related, method is being fully informed on political, economic and regulatory developments of relevance to the system, its business model—and its investment portfolio. A third (long-term) way is repositioning the composition and structure of the board to ensure responsiveness to these and similar developments. A fourth way is thorough understanding of the board’s role as a partner to the executive management team.

Such heightened commitment will directly support the director’s performance of his or her oversight and decision-making duties during this cycle of renewed uncertainty. The general counsel can help coordinate executive team support to the board as it seeks to increase engagement.

PARENT/SUBSIDIARY RELATIONSHIPS

The New York state attorney general’s challenge to the allocation of funds within a tax-exempt nursing home system is proceeding through the state courts, with potentially significant implications for nonprofit health systems.

The state’s petition is styled as a proceeding to enjoin the defendant system from exercising allegedly unlawful control over its subsidiaries, for which it serves as sole corporate member. The petition had its genesis in the parent company’s decision to replace the board of a senior living subsidiary with members of the parent’s own board and representatives of the parent, and the parent’s decision to transfer surplus funds from one subsidiary to another, to offset losses.

The petition alleges several causes of action arising from the transfer of surplus funds from one senior living home subsidiary to the parent. The claims are based on alleged breaches of fiduciary duties owed by the parent to the subsidiary, and allegedly improper participation in numerous related party transactions through the exercise of control of the subsidiaries in violation of state law, and subsidiary governing documents.

A separate cause of action was based on allegations that the subsidiary was required to pay allegedly “unreasonable” management fees to the parent, in violation of state related party transactions law. The attorney
general’s complaint also named as defendants several of the parent company directors, as well as its CEO and CFO.

The state’s interest in pursuing the case may be grounded in historical concerns with the financial looting of senior living facilities by their owners/Managers. What is notable in this case, however, is the state’s focus on the allocation of surplus funds from one controlled entity in the system to others in order to help satisfy debt obligations of other subsidiaries. Also notable is the state’s suggestion that the parent company owes fiduciary duties to its controlled subsidiary corporations.

If sustained on remittal, the attorney generals’ arguments could potentially be applied (in the presence of egregious facts) to challenge otherwise normal and customary intra-system financial arrangements in nonprofit health systems.

RISKS OF AUTONOMOUS OPERATIONS

The legal compliance challenges arising from autonomous operational divisions, units and affiliates have been demonstrated in a recent high-profile corporate development.

The development involved the prominent and internally favored division of a major US corporation. The division had enjoyed substantial success and public accolade for a lengthy period, earning the ability to operate independently from the primary corporate hierarchy. However, according to a report by independent counsel commissioned by the company’s board, the division’s autonomy served to shield substantial indications of harassment and misconduct by division leadership. Reportedly, the investigation concluded that not only had the division’s leader engaged in certain acts of sexual misconduct with colleagues, he had also failed to stop similar behavior by others in the division.

According to media reports, the extent of the autonomy created “physical, administrative and cultural separation” from the rest of the corporation, which allowed the misconduct to carry on without intervention. The incidents of alleged harassment have led to significant reputational and financial damage to the corporation and to key officers and directors.

The extent to which autonomous structures can create compliance risks was famously highlighted in the Wells Fargo sales model controversy. A principal investigatory conclusion was that the company’s decentralized organizational structure contributed significantly to the controversial practices. The investigative report noted that there was nothing “pernicious” about such a structure on its own, but in the context of the distorted Wells Fargo sales model, the structure became a significant catalyst for broader harm. The company had historically fostered an organizational culture of deference to the management of individual business lines, including deference in matters of oversight, risk and compliance. This proved toxic in the context of the sales model.

CULTURE AS AN INVESTIGATION TARGET

Both government enforcement actions and internal corporate investigations are increasingly citing alleged flaws in corporate ethics culture as the catalysts for corporate wrongdoing.

A leading example is the recently released Michigan attorney general’s report examining how Michigan State University addressed the circumstances surrounding former sports doctor Larry Nassar. The report criticized the university for fostering what it described as a “culture of indifference towards sexual assault, motivated by its desire to protect its reputation.” The report similarly criticized what it described as the university’s “culture of institutional protection” as prompting various forms of “stonewalling” internal investigations of Nassar’s actions in response to allegations of sexual assault.

This report follows several similar circumstances in recent months, arising from internal and external investigations and reviews of executive and governing board conduct at major universities, major corporations and even a major utility, relating to various forms of alleged conduct (not only sexual harassment). These investigations share a common thread: the culture of the organization, or the board, is identified as a major contributing source of the alleged misconduct or malfeasance. For example, one prominent report of a university football program (which had suffered the death of a player) cited a “culture in which problems fostered because too many players feared speaking out.” In several high-profile circumstances, regulators are citing flawed cultures as justifying removal of the entire board.

In this regard, regulators are following a trend that had its beginning in prior investigations of companies such as
GM, a major ride sharing corporation and Wells Fargo. The focus on organizational culture is also consistent with elements of the Federal Sentencing Guidelines and the US Department of Justice (DOJ) Principles of Federal Prosecution of Business Organizations.

In some respects, “flawed culture” is becoming the go-to allegation for those conducting investigations of corporate conduct. In response, the board should focus more time and resources on monitoring the organizational culture and leadership tone for indications that they may be incentivizing conduct inconsistent with the company’s mission and purposes. The general counsel can be an extremely helpful guide in this process.

**THE APPEARANCE OF CONFLICT**

A current ethical controversy involving a senior Trump Administration official provides a useful example of the nuances involved when evaluating circumstances involving the “appearance” of conflict.

There is no explicit best practice that requires boards and their governance committees to enforce conflicts policies for relationships and arrangements that create the appearance of conflict but do not give rise to an actual conflict. Many board conflict policies address appearance issues given reputational or “optics” concerns. However, these policies should be applied carefully and in the reasoned discretion of the governance committee (e.g., appearance to whom?)

According to news reports, the administration official sought the advice of his department’s ethics officer, as well as that of several other government officials, in evaluating whether his prior public statements critical of an ongoing special counsel investigation should require his recusal from oversight of the investigation. The ethics officials concluded that if a recommendation were sought, they would advise the official to recuse himself because it was their view that a reasonable person with knowledge of the relevant facts likely would question the impartiality of the official. However, by policy, the administration official was not obligated to accept the recommendations of the ethics officials.

The facts in this matter, and the department’s conflicts rules, are complex. However, the “appearance” standard applied by the ethics officials (reasonable person with knowledge of relevant facts) and the ultimate focus (the question of impartiality) go to the core of similar conflicts deliberations by a board governance committee in a corporate setting. This matter thus serves as a useful reminder for the board’s governance committee to re-evaluate the manner in which it deals with circumstances that only present the appearance of a conflict.

**FODDER FOR THE COMPLIANCE COMMITTEE**

The vitality and prominence of the board’s corporate compliance committee may be strengthened by 2018 False Claims Act statistics recently released by DOJ.

The statistics demonstrate that of more than $2.8 billion recovered by DOJ in FCA-related settlements and judgments in the last year, $2.5 billion (roughly 89 percent) involved the health care industry (e.g., drug and medical device manufacturers, managed care providers, hospitals, pharmacies, hospices, laboratories and physicians). This represents the ninth consecutive year that DOJ civil health care fraud settlements and judgments have exceeded $2 billion. While the largest FCA recoveries in 2018 came from the drug and medical device industry, significant recoveries were also obtained from prominent health care provider organizations, according to the DOJ release. The release also noted the extent to which the FCA was used to penalize fraud by individuals in the health care sector, as well as by corporations.

The board’s compliance oversight obligation—whether pursued in a dedicated single purpose committee (e.g., the compliance committee) or a committee with multiple tasks (e.g., the audit and compliance committee) remains a critical governance function. Deregulation efforts by the current administration, including the possibility of amendments to the Stark Law to address barriers to coordinated care, may cause some to question the resources applied to compliance function and the portfolio of the compliance committee, but the new False Claims Act statistics make abundantly clear the federal government’s continued interest in civil investigations involving false claims submitted by health care organizations.

These statistics, together with the recently revised provisions of what was known as the Yates Memorandum, combine to buttress the continued importance of the compliance committee. The general counsel, teaming with the compliance officer, is well positioned to brief compliance committee members on the significance of the DOJ statistics.
NEW EXEMPT ORGANIZATION TAX GUIDANCE

Health system executive compensation committees should consult with their general counsel concerning new Internal Revenue Service (IRS) interim guidance on key compensation issues arising from the 2017 Tax Cuts and Jobs Act.

On December 31, 2018, the IRS released interim guidance on the provisions of the new § 4960 added by the Tax Cuts and Jobs Act, and announced the intent of the US Department of Treasury and the IRS to issue proposed regulations. As most general counsel will recall, § 4960 provides that excess remuneration and excess parachute payments paid by an applicable tax-exempt organization to a covered employee are subject to an excise tax (currently 21 percent) (the so-called High Five Tax).

Prior to December 31, 2018, the IRS had provided no guidance on the executive compensation excise tax created by the Act and promulgated under IRC § 4960. The December 31 notice provides interim guidance defining (1) “applicable tax-exempt organization,” (2) “excess remuneration,” (3) “covered employee” and (4) “excess parachute payment.” The notice also instructs taxpayers on how to report and pay the excise tax.

According to partner Ralph DeJong, it is not surprising that the guidance has been issued in the form of a notice, rather than proposed regulations. However, the scope and detailed nature of the guidance is surprising. The guidance is substantial, covers all the major § 4960 open issues in detail, and offers helpful examples and rationale.

According to Ralph, exempt organizations will find the guidance on the effective date of § 4960 to be straightforward but helpful. Remuneration is determined based on the calendar year ending within the exempt organization’s taxable year, which might seem overly inclusive in 2018 for fiscal year organizations, but special rules exclude remuneration that vested or is treated as having vested before the effective date of § 4960. Organizations with significant deferred compensation arrangements that built up substantial vested amounts before the effective date are likely to benefit from these special rules.

The more difficult aspect of the guidance for exempt hospitals and health systems relates to highly compensated physicians serving in roles other than direct patient care, Ralph notes. The guidance allows the exclusion (from remuneration subject to the excise tax) of only the portion of pay for direct patient care personally provided by the physician. Remuneration for other services, including medical supervision, research, teaching and other activities that clearly must be provided by a licensed medical provider, still count in calculating the potential excise tax.

Exempt organizations will be challenged to understand and implement this substantial guidance quickly in 2019, so that they can determine the tax impact and consider operational changes that could reduce their § 4960 tax exposure.

GENDER EQUALITY

Boards must be prepared to address internal issues associated with the promotion of women within the organization, as the #MeToo movement is evolving into a serious discussion of gender equality.

This issue has vaulted to the forefront of boardroom discourse with the recent McKinsey report on women in the workplace, and related developments. This report, prepared with support from LeanIn.com, calls for decisive action by companies to address the promotion of women across all levels of the organizational hierarchy. It is a report that must be brought to the board’s attention; it makes clear that the topic of gender parity and issues involving sexual discrimination and harassment are inextricably intertwined.

The report identifies a series of notable warning signs. While women are joining the workforce at the highest level in years, only 25 percent of senior executives are women, and even fewer are women of color. The data indicates that women begin to lag behind in terms of promotion and advancement almost from the beginning of their employment. This gap is even more pronounced in some industries (e.g., health care and retail) where the number of women employees often outnumber those of men. This level of disparity has not narrowed in recent years, even as companies have become more attuned to matters of workforce culture.

Many boards have already taken a series of measures in response to the #MeToo movement, such as improved whistleblower programs, enhanced penalties for incidents of harassment and abuse, and increased numbers of women on the board. The open question is whether such measures are sufficient to address the more corrosive
effects of gender inequality, reflected most dramatically in the “onlyness factor”—being the only women in the room. And these can be issues that truly find their way to the bottom line. Gender equality is likely to become a major component of the board’s oversight of workforce culture.

TRUMP FOUNDATION RELEVANCE

The New York attorney general’s ongoing enforcement action against the Trump Foundation and its officers and directors is relevant to nonprofit health systems, any political connotations notwithstanding.

The Trump Foundation was incorporated as a private nonprofit corporation with purposes consistent with IRC § 501(c)(3). The attorney general’s original complaint alleged, in essence, that the foundation had conflated political and charitable considerations through willful self-dealing and failure to satisfy basic legal requirements. Specific causes of action were grounded in waste, breach of fiduciary duty, violation of statutory requirements and related party allegations. Among the relief sought was a judicially supervised dissolution and a ban on future nonprofit service by the officers and directors.

A November 23, 2018 decision sustained all but one of the causes of action (relating to a preliminary injunction), and the parties entered into a stipulation relating to the dissolution of the foundation on December 19, 2018. According to published reports, the attorney general continues to pursue foundation officers and directors (the president and his children) on the fiduciary breach, waste of assets and related allegations.

The Trump Foundation enforcement action is relevant to the extent that it demonstrates how a state attorney general may pursue an enforcement action against a nonprofit corporation accused of “a pattern of persistent illegal conduct.” The individual allegations against foundation officers and directors, and the relief sought against them (and the foundation), are illustrative of the causes of action that a state attorney general may bring to bear against board members in extraordinary circumstances.

GOVERNANCE AND NEW FITCH, MOODY’S REPORTS

Important new reports on nonprofit health care from both Fitch Ratings and Moody’s Investors Service are useful reading for all board members, not just those who serve on the finance committee.

A leading observation from Fitch is that acute care credit strength, as measured by operating profitability, is set to decline for the third consecutive year. Conversely, acute care credit strength as measured by conventional balance sheet metrics is currently at an all-time high. Fitch also observed that larger systems appear more able than smaller providers to benefit from a variety of cost-reduction methodologies (e.g., efficiency, elimination of waste and transformation of care).

Moody’s offered a negative outlook in 2019 for nonprofit health care, with revenue growth to be constrained by a combination of weak volume trends, low single-digit reimbursement rate increases and a higher number of Medicare payments. Moody’s also expects bad debt to increase as a result of higher patient copays and deductibles. However, expense growth is expected to slow, in response to cost-cutting programs and lower drug price increases. Moody’s also identified several factors that could support a positive outlook.

Not all directors are expected to be financial experts, and there is no expectation that the entire board be familiar with the financial detail typically contained in special reports from credit ratings and other investor service firms. But as financial stewards of the organization, the entire board (not just the financial committee) should be briefed on conclusions and projections contained in well-prepared reports from reliable industry experts, like Moody’s. This is particularly the case when the report reflects financially significant trends and developments.

It is certainly acceptable that the CFO summarize such conclusions and projections for the full board in an understandable manner. Such information is often best provided in the broader strategic and competitive context —i.e., increasing pressures on the inpatient hospital model, and the fact that competing for-profit and nonprofit hospitals are similarly affected by these trends.

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