IMPORTANT BOARD COMPOSITION DEVELOPMENT

The board’s nominating committee will benefit from an overview of The Conference Board’s important new survey on board composition, turnover and refreshment.

According to the survey, the composition of many public company boards remains unchanged, despite widespread demand for greater refreshment and diversity. The report documents governance trends and developments at several thousand companies, and is relevant not only to public companies, but also to private companies and sophisticated nonprofit organizations.

Almost half of the surveyed companies disclosed no change at all in their board composition—they neither added a new director nor replaced a sitting director. In circumstances where replacement or addition did occur, it usually affected only one board seat. But even that refreshment is of limited significance, given that the average director tenure of surveyed directors exceeds 10 years, and approximately 25% of directors who step down do so after more than 15 years of service.

The survey describes as “staggering” the data indicating that 20% of the Russell 3000 still have no female representation on their boards. Furthermore, while women are being elected to board positions in larger numbers than before, the survey concludes that men dominate board chair positions. And there’s more than gender diversity at issue: the report concludes that corporate boards are “inaccessible” to the younger generation of business leaders.

Board refreshment is further stymied by a lax approach to evaluating individual director performance. The report concludes that only 14% of Russell 3000 companies disclose an annual process to evaluate the contributions of individual directors.

The significance of The Conference Board’s report will likely result in greater scrutiny of board nominating practices. It may add impetus to legislative and regulatory efforts to mandate diversity requirements, and may affect the corporation’s reputation among consumers, business partners and the workforce.

NEW DOJ COMPLIANCE GUIDANCE

The board’s audit and compliance committee should be briefed on comprehensive new compliance program guidance issued by the US Department of Justice on April 30, 2019.

The new guidance document discusses in detail the three main factors that prosecutors typically use in evaluating corporate compliance programs:

- Part I: the various hallmarks of a well-designed compliance program relating to risk assessment, company policies and procedures, training and communications, confidential reporting structure and investigation process, third-party management, and mergers and acquisitions. This includes new focus on the effectiveness of the company’s risk assessment and the manner in which the company’s compliance program has been tailored based on that risk assessment.
Part II: features of effective implementation of a compliance program, including commitment by senior and middle management, autonomy and resources, and incentives and disciplinary measures. This includes new focus on "tone at the top" and other indications of support for the compliance program from gatekeepers, executive leadership and the board.

Part III: metrics of whether a compliance program is in fact operating effectively, exploring a program's capacity for continuous improvement, periodic testing and review, investigation of misconduct, and analysis and remediation of underlying misconduct. This includes new focus on how the company both detects misconduct and responds to situations in which misconduct is detected.

The board’s audit and compliance committee is typically responsible for ensuring the effectiveness of the organization's compliance program. In connection with this responsibility, it works with both the general counsel and the chief compliance committee to exercise proper program oversight. This new DOJ guidance is particularly relevant to board duties in this context, given that the guidance reflects how DOJ prosecutors analyze the quality of individual corporate compliance programs.

NEW DOJ GUIDANCE ON COOPERATION CREDIT

Separate from the new guidance on compliance program effectiveness, DOJ has also released important guidance on when it will grant "cooperation credit" in False Claims Act (FCA) investigations.

The new guidance, released on May 7, 2019, sets forth the manner in which DOJ will award credit to defendants (e.g., corporations) that cooperate with DOJ in the context of an FCA investigation. In particular, the guidance identifies how cooperation credit in FCA cases may be earned:

- By voluntarily disclosing misconduct unknown to the government (which DOJ says is the most valuable form of cooperation)
- By cooperating in an ongoing investigation
- By undertaking remedial measures in response to a violation (e.g., through new or improved compliance programs)

Notably, the guidance allows for cooperation credit even in situations where the government already has initiated an investigation. For example, a health system may be entitled to credit for making a voluntary self-disclosure of other misconduct outside the scope of the government’s existing investigation that is unknown to the government. As another example, a health system may be entitled to credit where it preserves relevant documents and information beyond existing business practices or legal requirements, identifies individuals who are aware of relevant information or conduct, and facilitates review and evaluation of data or information that requires access to special or proprietary technologies.

All of this is relevant to the work and responsibilities of the compliance committee. While it may be based upon the recommendations of management and legal counsel, the ultimate decision on whether to seek cooperation credit is likely to be made by the governing board, in consultation with (or in reliance on the advice of) the compliance committee. It thus makes sense for the compliance committee to maintain a working familiarity with this new DOJ guidance generally, and with the concept of cooperation credit in particular.

A NEW CORPORATE OPPORTUNITY DECISION

A complex set of facts involving dual employment and nepotism provides the basis for another state appellate decision applying the doctrine of corporate opportunity to determine a breach of fiduciary duty.

The case involved a corporate executive of an oral care products company who simultaneously accepted a position with a competing enterprise. The executive also caused his daughter to be employed by the competing enterprise and to be hired as a broker by his primary enterprise.

While the corporate executive was ultimately terminated by his primary enterprise, his daughter instituted the litigation, seeking to recover unpaid brokerage commissions from the primary enterprise. That enterprise successfully counterclaimed against the father, daughter and competing enterprise, recovering a judgment for breach of fiduciary duty. The trial court determined that the corporate executive had, among other breaches, deprived the competing enterprise of a corporate opportunity by acquiring an ownership interest in the competing enterprise without first disclosing it to the primary enterprise.

In affirming the decision of the trial court, the Illinois Appellate Court noted that the corporate opportunity doctrine operates to preclude a fiduciary from usurping a business prospect that he or she developed through the use of corporate assets. It further concluded, consistent with common law and statutory principles, that when
a fiduciary seeks to take advantage of an opportunity within his or her company’s line of business, the fiduciary must first ask permission to do so. Whether the company is legally or financially capable of taking advantage of the opportunity itself is not a consideration (e.g., the fact that in case both the primary enterprise and the competing enterprise were in the same line of business).

The underlying significance of this decision is twofold. First is the increasing sensitivity of corporations to protecting their interests from breaches of fiduciary duty by officers and directors. Second, and closely related, is the increasing willingness of corporate plaintiffs to apply theories of corporate opportunity to establish a breach of fiduciary duty (and their success in doing so). Such significance suggests the value of periodic, frank discussions between board leadership and other members of the leadership and management team on concepts of fiduciary responsibility generally, and what may actually constitute a “corporate opportunity” in particular.

THE ROLE OF FINANCIAL INCENTIVES IN SUPPORTING COMPLIANCE OBJECTIVES

A recent Harvard-sponsored roundtable on corporate compliance provides additional support for the role and potential of compensation in advancing an organization’s compliance-related goals.

A portion of the roundtable discussion was premised on the view that compensation and other financial awards or sanctions are an important tool to align the company’s interest in respecting the law with the interests of its individual agents. While acknowledging that financial incentives are already incorporated within current corporate compliance practices (albeit to differing degrees), the roundtable observed that compensation policies linked to compliance often lack sophistication and rigor.

The roundtable specifically focused on two elements of compensation-styled compliance incentives. One element was the value of properly designed clawback policies as a powerful compliance tool, subject to several Ben Heineman, Jr., suggested conditions:

- Acts of malfeasance giving rise to clawbacks should be far broader than financial misreporting.
- Clawbacks should be applied to supervisors deemed negligent in applying sufficient compliance measures and establishing a proper compliance culture in the organizational unit where the compliance failure occurred.

The other element was the compliance risks that can be created by overly ambitious and unrealistic targets for management and employees. Roundtable participants agreed that these risks can be mitigated through the following steps:

- Setting business and compensation targets realistically and reasonably
- Adding relevant compliance and conduct targets to the business key performance indicators (KPIs)
- Controlling, measuring and weighting performance with regard to compliance and conduct targets as if they were business KPIs

The use of compensation as a tool to promote compliance has long been referenced by the Federal Sentencing Guidelines’ compliance plan effectiveness guidelines, and more recently by the new US Department of Justice compliance plan guidance. It is appropriate for the board’s audit and compliance committee, perhaps teaming with the executive compensation committee, to give close consideration to how compensation and other financial incentives can promote corporate compliance.

IMPORTANT CREDIT RATINGS REPORTS

Separately issued health industry reports from two major financial information and analytics firms provide interesting insights for boards on the credit implications of business disruption and competition, and on growth strategies beyond core competencies.

S&P Global’s May 13, 2019, report, “Effective Management Continues to Enable Not-for-Profit Health Care To Adapt,” acknowledges the sector’s resilience despite a multitude of pressures, such as changes in payment delivery, consumerism, population health, heightened focus on quality measures and outcomes, a fundamental shift in how and where patients are treated, and especially competition and technological disruption. The report underscores the significant emergence of innovative business models and competitors, which “are more than happy to let hospitals and health systems operate in [the inpatient business].”

This resilience is attributed in large part to strong management and governance in the not-for-profit health care sector. As a result, S&P is optimistic that (at least the majority of its rated portfolio in) that sector is “well positioned to compete effectively as new strategies are required.” This, despite an expectation that the pace of
health care evolution will quicken with time.

Moody’s Investors Service May 16, 2019, Not-for-Profit Healthcare Report discusses the credit implications of not-for-profit hospitals’ pursuit of alternative growth strategies—those outside their core competencies. In general, it observes that the wave of mergers and acquisitions is limiting health system expansion opportunities in home markets. With this trend, larger systems are increasingly pursuing other avenues of growth, including new markets, new business ventures and nontraditional partnerships.

Moody’s concludes that of the three, new business ventures—including health insurance and long-term care—carry the greatest credit risk. While health systems will continue pursuit of new business ventures in order to diversify revenue streams amid declines in traditional inpatient care, such ventures (particularly the operation of an insurance plan) create risk because they are outside management’s traditional areas of focus.

Moody’s views acquisitions in new markets as involving execution risk, but subsequent operations are typically within management’s core competencies. The report sees “nontraditional partnerships and joint ventures” as continuing to provide growth opportunities with more limited financial risk, and with the benefit of allowing health systems to expand into new regions or launch ventures while leveraging a partner’s capital and brand.

Health-industry-specific credit reports such as these can be valuable oversight resources for health system board members, particularly those who serve on the finance, audit and strategic planning committees.

INCREASING FOCUS ON CEO ETHICS

Two recent surveys focus on concerns regarding CEO ethics and integrity, and the financial and reputational impact of such ethical concerns.

One recently released survey, prepared by researchers at Duke University’s Fuqua School of Business, concluded that CEOs with lower integrity cost their firms money, both in higher audit fees and in poorer long-term performance. Fuqua researchers identified a positive correlation between the CEO integrity measure and workplace reviews of the CEO. Conversely, the researchers observed that a primary cost of employing a low-integrity CEO is incrementally higher audit fees.

The Fuqua research suggests two reasons why auditors might charge higher fees for a firm with a low-integrity CEO:

- The auditors may suspect potentially undetectable fraud and require compensation for expected damage to their own reputations.
- The auditors are working harder to uncover potential fraud before it happens.

The Fuqua researchers also found that company performance decreases in the future when the CEO has low integrity—a finding consistent with other recent research concluding that firms with a general culture of high integrity outperform other firms.

A second recently released study, from Strategy&; (the strategy consulting affiliate of accounting firm PwC), indicated that CEO turnover in 2018 was at record levels (17%). More significantly, the study showed a rise in the share of CEOs removed for ethical reasons. For the first time in the survey’s history, the data indicated that more CEOs were removed for ethical reasons (39%) than for matters of board/investor turmoil (13%) or financial performance (35%). This represented an increase of 50% from 2017 results.

The ethical reasons prompting the CEO departures included scandal or improper conduct, which the survey defined to include fraud, bribery, insider trading, inflated resumes, sexual indiscretions or, interestingly, environmental disasters. Not surprisingly, much of the increase in ethics-based departures is concentrated in #MeToo-related concerns and other “zero tolerance” policy violations. The survey noted that the increase in ethics-based departures occurred despite the strong economy, reflecting an increasing interest in boards holding CEOs accountable to the same level as employees.

Questions of CEO integrity are important to all aspects of board leadership, and particularly to the audit and compliance, search and succession, and executive compensation committees. Issues associated with executive integrity and excessive risk-taking have also been raised in the portions of the new DOJ compliance plan guidance that focus on the important relationship between appropriate risk assessment and compliance effectiveness, and the extent to which senior executives are demonstrably supportive of compliance initiatives.

BOARD OVERSIGHT OF ARTIFICIAL INTELLIGENCE
A new *Harvard Business Review* article provides a useful summary of ways in which corporate boards may approach their oversight of corporate investments in artificial intelligence.

A key premise of the article is that adding one or two technology-focused members to the board may not be sufficient to support the full board’s ability to monitor the expected increase in the acquisition and application of AI in the coming years. This is consistent with a recent observation in *The Wall Street Journal* that every company must now be considered a “tech company”—with a related, profound impact on board composition.

The author offers four “guideposts” to which board members in any industry can refer as they orient themselves to the relationship of AI to their company:

- Don’t be intimidated by AI concepts—any proper application of AI is likely to be an extension of some aspect of current corporate operations.
- Traditional oversight skills are applicable to AI projects.
- The most effective AI projects should be easily explainable to the board, and if they are not, they may not be a good corporate fit.
- It may not be necessary for an effective AI project to mine a maximum level of data
- AI should be considered as an operating expense, as opposed to a capital investment.

The author summarizes key board AI oversight questions as consistent with any large opportunity investment: Why are we spending all this money? What’s the economic benefit? How does it affect our people and our long-term competitiveness?

There will be more boardroom discussion about the application of AI, and the board’s role in monitoring that application, as health care systems increase their related investment. Effective governance will increasingly depend on the extent to which directors are technology-literate and are keeping pace with digital transformation. The new *Harvard Business Review* article may help directors with fewer technology skills to work towards a basic understanding of AI and its disruptive potential.

### DEADLOCKED JOINT VENTURES

A significant new *Delaware Chancery* decision underscores the importance of addressing the potential for deadlock in 50/50 joint ventures involving the health system, as well as the ability of state courts to break a deadlock through judicial action.

This case involved the judicial dissolution of an LLC conducting business in the pharmaceutical sector. While the LLC had obtained substantial private equity funding for its drug development efforts, it had achieved only limited success in achieving production of approved drugs at the time of the litigation. As is often the case with shared ownership/governance arrangements, the founding members of this LLC were deadlocked on several critical operational issues, including the company’s strategic vision.

By providing the LLC members with veto rights and consent rights over decisions, the parties appeared to create the possibility for deadlock—and they also chose not to establish a methodology to resolve a potential deadlock (e.g., a buy-sell provision). That led the court to conclude that the LLC agreement failed to provide any alternate mechanism to resolve the deadlock. The court was particularly critical of the agreement’s provisions for dealing with conflicts of interest, which it found inherently “vague and ambiguous.” Thus, it determined that it was no longer reasonably practicable to carry on the company’s business in conformity with the LLC agreement (the precondition for judicial dissolution). Indeed, the court noted that its role was not to redraft the LLC agreement for “sophisticated and well-represented parties.”

Many health systems have numerous and disparate investments in joint venture arrangements, often with 50/50 ownership and governance arrangements. With many of these ventures, the opportunity for conflict, divergence of interests and disagreement between the owners/managers has increased, together with the financial sophistication of the ventures. There are credible perspectives that eschew dispute resolution clauses in favor of forcing joint venture parties to reach a compromise. However, the stakes of disagreement and deadlock can be quite high in operationally sophisticated joint ventures. This decision may serve as a prompt to health system general counsel to review the effectiveness of existing joint venture dispute resolution processes as a hedge against court-directed dissolution of the venture.

### NEW WAVE EXECUTIVE TITLES

The recent proliferation of new executive positions and titles typically reflects important corporate objectives, but boards should maintain awareness of the role and function of those new positions.
This trend is most recently reflected by Airbnb’s announcement that it is creating a position of chief trust officer. Titles such as chief innovation officer, chief automation officer, chief ecosystem officer and chief freelance relationships officer are consistent with the trend, and there are many other examples. The feasibility and success of these non-traditional but operationally significant titles and positions ultimately depend on two related factors.

First is the board’s attentiveness to the creation of these new positions. For example, the board should educate itself on the duties and responsibilities of the new corporate officer positions, as a precondition to their supervision of the (expanding) executive suite. Similarly, the board will be interested in how existing vertical and horizontal reporting relationships—including those to key board committees—are affected by the new positions. From a talent development perspective, the board will be interested in the potential for overlap, repetition, confusion and lack of coordination created by the new positions. Most importantly, the board will want to understand what the creation of the new positions, with their new responsibilities, says about the direction of the company’s business.

Second is the extent to which these new, non-traditional titles implicate legal considerations under the primary jurisdiction of the company’s general counsel; i.e., do their job responsibilities involve matters of law or regulation that require coordination and cooperation with general counsel? The general counsel must ensure that the legal aspects of the duties of this new class of executives are properly fulfilled. In doing so, the general counsel can rely on skills developed while working with more traditional corporate officers whose duties also have legal aspects, including the human resources director, the chief information security officer, the internal auditor and particularly the chief compliance officer.

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