The Duty of Care and the Board's Conflicts Resolution Process

Michael W. Peregrine, McDermott Will & Emery LLP

The comprehensive application of duty of care principles is a critical element of effective board conflicts resolution processes. This is especially the case as boards and their legal/ethics advisors seek to upgrade existing policies to address new conflicts concerns arising from the transformation-based expansion of the health system portfolio.

Much of the attention in the policy upgrade process is normally focused on duty of loyalty obligations of officers and directors to (1) avoid arrangements that could give rise to actual or potential conflicts of interest; (2) be alert to the potential that pending or current arrangements could be interpreted as creating an actual or potential conflict of interest;[1] and (3) disclose, pursuant to established procedures, the existence of arrangements that could constitute an actual or potential conflict of interest. This is the "sizzle" of the process.

However, even the most refined duty of loyalty compliance cannot alone support the effectiveness of a conflict of interest policy if the process by which the board evaluates disclosures is not consistent with the duty of care.[2] That process traditionally involves (among other tasks) (1) a delegation of conflicts management duties to a specific board committee; (2) how the board/committee makes, confirms, and monitors its decisions; (3) committee meeting frequency and board reporting; and (4) enforcement of policy violations. These are the "nuts-and-bolts" of the process.

Both case law and authoritative treatises underscore the expectation that directors will apply a higher degree of scrutiny to transactions involving a business transaction with an officer or director, as opposed to a one with a third party.[3]

What's Driving the Scrutiny?

A renewed focus on the conflicts of interest process is prompted by the seismic changes currently roiling the health care industry, many of which have direct implications for the process by which conflicts are identified, disclosed, and addressed at the leadership level. These include:

- The significant diversification of health system portfolios, particularly those involving investments in innovative technology and new delivery of care platforms;
- The increasing interest of officers and directors in "investing along" with the health system in certain business arrangements;
- The rapid consolidation of the inpatient health care provider market and the evolving determination of what is a "competitor";
- The emergence of non-traditional market participants, whether they be the Silicon Valley "disruptors," or powerful new organizations formed through vertical or horizontal combination;
- The impact on regulators of the intense media scrutiny of Washington, D.C. conflicts of interest allegations;
- The presence of constituent directors on corporate and joint venture boards; and
- New case law focusing on how personal interests may affect leadership decisions.

These and other factors serve to increase the scope, significance, and materiality of the conflicts of interest process and the expected standard of board conduct. Continued reliance on processes strictly grounded in decades-old Internal Revenue Service (IRS) standards, or on those intended only for small or moderately sized business organizations, will not serve the interests of large, diversified health care enterprises. Boards will be held accountable for the failings of weak or outmoded conflicts processes.

Key Procedural Elements

As noted above, effective conflicts of interest policies depend on exercise of the duty of care by directors and committee members in the policy's review and decision-making process. This is particularly the case as to the following elements of that process:

Committee Delegation. For most health care systems, leadership conflicts issues are too numerous and complex to be addressed by the full board and are more effectively addressed at the committee level; e.g., the Governance Committee or a dedicated Conflicts Review Committee. Nevertheless, the full board should be directly involved in the delegation process—to what Committee is the responsibility given; how does the delegation affect the Committee's charter; the finality of Committee decisions (or not); and whether the Committee as composed and organized has sufficient time and energy to address conflicts issues. Such steps will be supportive of the board's ability to rely on the decisions of the Committee.

A renewed focus on the conflicts of interest process is prompted by the seismic changes currently roiling the health care industry, many of which have direct implications for the process by which conflicts are identified, disclosed, and addressed at the leadership level.

Committee Composition. As part of the delegation, the board should establish several key guidelines for Committee composition. First and foremost, Committee membership should be comprised of independent members of the board: the presence of members who can be perceived as "beholden" in some way to the implicated director or otherwise as "interested" will undermine the process. Second, Committee members should possess the personal traits of diligence, perception, and ethical sensitivity that are essential to conflicts analysis. Third, Committee members must have the time and capacity necessary to satisfy the Committee's (growing) agenda.

Committee Staff. The board will want to confirm that the Committee has proper resources from the executive leadership team; e.g., participation from the Chief Legal Officer (CLO) and the Chief Compliance Officer (CCO). The CCO is well-suited to manage the mechanics of (and adherence to) the conflicts disclosure process, while questions implicating the duties of loyalty and care, as well as related legal analysis and interpretation, require input from the CLO.

Their Own Conflicts. The Committee will want to recognize the potential that issues presented for resolution could actually prompt conflicts of interest for individual Committee members. Could they be in a similar position? Do they have a close personal relationship with the disclosing director? Do they have some other material connection to the issue at hand such that it could conceivably bias their decisions? Are there "optical" issues?

Resolution Mechanics. Consistent with heightened duty of care expectations, the mechanics by which the Committee considers conflicts disclosures should be formalized commensurate (in terms of timing and detail) with the size and operational sophistication of the corporation. For that reason, it may be wise for the Committee to periodically evaluate the effectiveness of its procedures, beginning with the receipt of disclosure,

to diligence by the Committee, to input from the implicated officer or director, to the issuance of a decision.

Standards for Evaluation. As noted above, the actual process by which the Committee reaches a decision on whether a particular disclosure constitutes a real or apparent conflict of interest should be designed to evaluate whether the implicated arrangement is fair to the corporation. For that reason, the Committee is encouraged to apply written standards for its evaluation of disclosed conflicts. While this should not prevent the Committee from acting *ad hoc* as the circumstances may warrant, the application of pre-established evaluation criteria will help support the consistency and good faith of the review process.

The Committee will want to recognize the potential that issues presented for resolution could actually prompt conflicts of interest for individual Committee members.

These written criteria may include questions designed to focus on such matters as the materiality of the implicated interest; whether the officer or director's interest was direct or indirect; how the officer or director was presented with the particular opportunity; whether the transaction/arrangement was the byproduct of improper influence or entered into with knowing disregard of corporate policy; whether disclosure was timely and fully made; and the impact of the transaction/arrangement (were it to be approved) on the reputation of the organization—among other factors.

The criteria also should address the extent to which the process is insulated from outside pressures (e.g., the presence of close relationships on the board or in management that may interfere with the ability of Committee members to evaluate a disclosure with the needed level of scrutiny). In particular, the criteria should guide the Committee when considering fact patterns in which the nature and extent of interests and relationships, controlling influence, and/or materiality are at the surface unclear or nuanced.

Rebuttable Presumption. Many state for-profit and nonprofit codes contain "rebuttable presumption"-styled statutes relating to director conflict of interest.[4] While they may vary from state to state, these statutes generally provide that a transaction between the corporation and an officer or director (or any entity in which such an individual has an interest) is not void or voidable solely for that reason if (1) the material facts are disclosed and the independent, non-conflicted members of the board in good faith authorize the transaction by majority vote; or (2) the transaction is fair at the time the transaction is authorized.

Note that the bases for rebuttable presumption treatment are grounded in some affirmative action by the Committee, which would be subject to the duty of care and for which business judgment rule protection may be available. Note also that these statutes, and the sparse case law arising thereunder, do not provide particular direction on the party (e.g., the corporation, a shareholder or member, a contracting party) that may challenge a conflict of interest transaction—rebuttable presumption or not. This is especially the case with respect to nonprofit corporations, but it should be assumed that the state attorney general will almost always have a jurisdictional basis from which to challenge a nonprofit board's conflict of interest review process.

There can be significant benefits to the corporation from satisfying the applicable rebuttable presumption statute; e.g., the opportunity to shift to a challenger the burden of proof as to the unfairness of the transaction to the corporation. However, these statutory provisions implicate a number of complex fiduciary considerations and lack a body of interpretive case law. Any decision regarding the application of such a statute should be made on the advice of the CLO.

"Compelling Benefit." An additional level of analysis is offered by the Association of Governing Boards of Universities and Colleges, in its "Statement of Conflict of Interest" publication.[5] The Statement includes a particular recommendation that conflict of interest transactions should only be approved when the board determines that the transaction would result in "compelling benefit" to the institution and is subjected to specific conditions intended to "assure propriety and the appearance of propriety."

This "compelling benefit" standard ("Standard") is a thoughtful and well-intentioned supplement to the conflicts resolution process. As the Statement notes, however, the Standard "*may or may not in a given situation correspond to performance of a legal duty*" [emphasis added]. Indeed, the Statement acknowledges that the Standard is different from state conflicts of interest laws, and IRS standards for tax-exempt organizations. Its application—whether by academic medical centers or other health systems—should be carefully considered and applied only with the advice of the CLO. The undisciplined use of the Standard could conceivably be applied to circumvent the legitimate purposes of the review process (e.g., to the extent it marginalizes legal risks in favor of business objectives or personal interests).

The board/Committee must be perceived as willing and able to enforce conflicts of interest policy violations.

Management Plans. The "conflicts management plan" is a traditional approach to supervising conflict of interest transactions that may be approved by the Committee for reasons of "compelling benefit" or other legitimate interests of the organization. Such plans should be incorporated in a written document, signed by all involved parties, that articulates goals, objectives, monitoring criteria, and enforcement and termination provisions to protect organizational interests and reduce the possibility of private benefit and self-dealing. Whether to adopt and supervise a conflicts management plan in a particular circumstance will require the concerted exercise of the Committee's duty of care and should be structured consistent with business judgment rule elements.

Timing & Reporting. In its delegation of authority to the Committee, the health system board should articulate expectations for meeting frequency that are sufficient to allow thoughtful resolution of particular conflicts issues in advance of the board (or other committee) meeting in which the implicated transaction or arrangement is to be addressed. The ad hoc/"real time" resolution of such issues immediately before a related vote should be avoided at all times.

Similarly, the Committee charter should set forth a reporting process intended to keep the board fully informed of conflicts issues that come before the Committee (and their resolution). This will facilitate the work of the full board, and of other committees, to the extent that they are affected by individual director duty of loyalty compliance.

Enforcement Powers. The board's duty of care responsibilities extend to the ability to enforce (either directly, or by delegation to the Committee) obligations under the conflicts of interest policy and to penalize individual officers and directors for violations thereof. Enforcement powers usually range from referral to the director evaluation and/or re-nomination processes (for ministerial or unintentional violations) to removal (for intentional breach of the duty of loyalty). The board/Committee must be perceived as willing and able to enforce conflicts of interest policy violations.

Relationship to Code of Conduct. Many corporations have a code of conduct, code of ethics, or similar policy that sets forth in broad based terms certain expectations of conduct applicable to officers and directors. Often times such a policy incorporates a reference to the avoidance of conflicts of interest. It will be important that the Committee obtains assurance from executive staff that any such reference is meant to refer to, and is not inconsistent with, the board's formal conflict of interest policy. This will help avoid the confusion that may otherwise arise between formal board policies and more casually written codes of conduct.

Conclusion

Much of the focus on duty of loyalty obligations of health system officers and directors justifiably is placed on the avoidance of conflict of interest situations where possible, and their willingness to identify and then fully disclose them when they cannot be avoided. However, the duty of care obligations associated with the process by which conflicts disclosures are resolved are equally important. Process counts—and is to be overseen by the board or a dedicated Committee. Otherwise, well-intentioned directors and Committee members can unintentionally subject themselves to breach of the duty of care by their failure to assure a conflicts review process that is commensurate with the operational complexity and portfolio sophistication of the health system. C

[T]he duty of care obligations associated with the process by which conflicts disclosures are resolved are equally important.

Michael W. Peregrine, a partner at McDermott Will & Emery LLP, advises corporations, officers, and directors on matters relating to corporate governance, fiduciary duties, and officer-director liability issues. His views do not necessarily represent the views of McDermott Will & Emery or its clients.

Endnotes

1 These obligations are grounded in core duty of loyalty principles requiring directors to act in good faith and in the best interests of the corporation and to avoid transactions or arrangements that raise issues with fairness and self-dealing, among others.

2 In most states, the duty of care involves determining whether the directors acted (1) in "good faith," (2) with that level of care that an ordinarily prudent person would exercise in like circumstances, and (3) in a manner that they reasonably believe is in the best interest of the corporation.

3 *See, e.g.*, Am. Bar Ass'n Comm. on Nonprofit Corp., Revised Model Nonprofit Corporation Act (3d ed. 2008) (Revised Model Act); *Conflicts of Interest and the ALI Corporate Governance Project: A Reporter's Perspective*, 48 Bus. Law. 1377 (Aug. 1993).

4 *See, e.g.*, 805 Ill. Comp. Stat. 105/108.60; Revised Model Act, *supra* note 3, at Section 8.60.

5 AGB Bd. of Directors' Statement on Conflict of Interest with Guidelines on Compelling Benefit (©2013 Ass'n of Governing Bds. of Univs. and Colleges), http://agb.org/sites/default/files/agb-statements/statement_2013_conflict_of_interest.pdf.