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T. Legal Ethics Case Study: Real World Governance Issues, Problems and Solutions

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THE CAST OF CHARACTERS

A. **THE CORPORATE PLAYERS:**

1. Eutheran University Health System ([EUHS]) is the parent organization of a multi-hospital health system located in the city of Faber (metropolitan population 500,000). EUHS serves as the sole corporate member of three hospitals: (a) the flagship facility, Eutheran University Medical Center ([EUMC]), a 450 bed academic medical center affiliated with Eutheran University School of Medicine, (b) Eutheran Metro Hospital ([Metro]), a 200 bed hospital located in a financially distressed area of Faber and which was acquired by means of a change of membership in 1997; and (c) Eutheran Heights Hospital ([Heights]), a 325-bed facility located in a prosperous Faber suburb. Each of the EUHS entities is a nonprofit corporation, recognized as income tax exempt under Section 501(c)(3) of the Internal Revenue Code.

2. EUHS is governed by a 45 person board of directors, the majority of whom are independent community leaders. Many EUHS board members are major benefactors of the institution, and also maintain broad social, philanthropic and charity board commitments beyond their EUHS service. Accordingly, many such directors only infrequently attend EUHS board meetings. Therefore, the board only meets four times per year, and most EUHS governance functions are performed by a seven person Executive Committee. The members of the Executive Committee also serve on the boards, and constitute the Executive Committees, of EUMC, Metro and Heights, respectively.

B. **THE PRINCIPAL BOARD MEMBERS AND STAFF:**

1. ***Mr. Tony Rome:*** Mr. Rome is the long-time chairman of the board of EUHS. Retired from the leisure and entertainment business, Mr. Rome is a prominent civic and community leader. He is well known as a dominant personality who prefers things [His Way.] He also is known as a generous benefactor of many charitable organizations, including but not limited to EUHS. Among his many investments is a minority partnership in Genco Olive Oil Company, a privately held company controlled by a distant relative, Mr. Vito Andolini, which owns, among other enterprises, the company that provides debt collection services to EUHS.

2. ***Mr. Vernon Dean:*** Mr. Dean is the new CEO of EUHS, having been recruited to the position by Mr. Rome. Prior to this, Mr. Dean had been the Chancellor of Faber University, where he was generally credited with restoring the financial fortunes of the University and significantly expanding programs and services. His reputation is also as a highly effective fund raiser. At Faber, Mr. Dean had overall responsibility for the operation of the University, the College of Medicine and a 150 bed health care facility, Faber University Hospital. Mr. Dean has never, however, been employed by, or consulted for, an acute care hospital. Mr. Dean serves as an ex-officio member, with vote, of both of the EUHS Board and of the Executive Committee.

3. ***Judge Theodore Smalls:*** Judge Smalls is the senior partner of the Smalls Law Firm, which serves as the principal outside counsel to EUHS. The Smalls Law Firm also represents Faber University on certain matters, among its other clients. Judge

Smalls is a EUHS Board member and serves as Vice Chair of the Executive Committee. In that role, he briefs Mr. Rome and the CEO (not the full board) on legal affairs, based upon reports provided him by Mr. Mason Perry, the engagement partner for EUHS.

4. ***Ms. Trisha ([Pepper]) Dickerson:*** Ms. Dickerson is the General Counsel of EUHS, having entered law school after a prior career in law enforcement.

5. ***Mr. Buddy Ono:*** Mr. Ono is recently retired entertainer who has announced his intention to run for Congress in the district in which the EUHS facilities are located. Mr. Ono, who is generally viewed as affable if not particularly analytical, serves as Chair of the Ethics and Conflicts Committee of EUHS.

6. ***Mr. Oliver Wendell Douglas:*** Mr. Douglas recently moved to Faber to resume the practice of law after a hiatus spent as an agrarian specialist in the community of Hooterville, 60 miles south of Faber. Mr. Douglas, a graduate of Eutheran University School of Law, is viewed as a mischief maker on the Board by Mr. Rome and has repeatedly been denied election to the Executive Committee.

7. ***Welby Marcus, M.D.:*** Dr. Marcus is the long-time Vice Chair and former CEO of EUHS. He is a beloved figure to both the medical staff and employees, and is a symbol to the EUHS service area of the high quality of care provided at the institution. Dr. Marcus has remained in his position well past normal retirement age, and during his years of leadership has presided over a dramatic decline in the physical condition of the institution and of its financial stability.

8. ***Professor Charles Princefield:*** The professor is Chair of the Accounting Department at the Eutheran University Graduate School of Business and is the Chair of the Audit Committee of EUHS. He has been outspoken in his recommendations concerning the need to promptly and dramatically address EUHS' financial problems.

9. ***Rob Patterson, HR Director:*** Rob is a career-EUHS employee whose particular focus is on employee policies and procedures, incentives and discipline. Mr. Patterson is also a member of a Eutheran religious sect which is known for extreme views regarding matters of diversity.

10. ***Mason Perry:*** Mr. Perry is a senior partner in the Smales Law Firm, is a well-respected member of the American Health Lawyers Association, and is the principal engagement partner for EUHS.

Nonprofit Governance Issues Associated with Setting and Background:

Δ The proper size and constitution of the governing board/the [Bifurcated Board]-the obligations and liabilities of non-Executive Committee members

Δ The independence of the Board and key Board committees

Δ The authority of the Executive Committee

Δ Limitations on board service with other organizations

Δ The extent of *Ex-Officio* status

Δ Proper communications involving the role of general counsel

Act I

We begin our melodrama at a special meeting of the Executive Committee, called by Mr. Rome to ratify his actions in negotiating the employment of Mr. Dean as CEO. The decision to replace the prior CEO, Dr. Welby Marcus, and to pursue Mr. Dean, had entirely been that of Mr. Rome, who has been concerned with the financial future of EUHS. He targeted Mr. Dean on the basis of his successful tenure at Faber. While Mr. Dean's employment contract with Faber was not complete and the Faber Board initially contested the EUHS advances (alleging [tortious interference]), Mr. Rome (with Mr. Andolini's assistance) made a persuasive offer to the Faber Board to release Mr. Dean from his contract. Citing both confidentiality of the matter and the risk of litigation with Faber, however, Mr. Rome had not kept the full EUHS Board advised of his activities, but had periodically informed several key members of the Executive Committee.

At the meeting, Mr. Rome was asked by Professor Princefield to describe the terms of the employment agreement with Mr. Dean. Mr. Rome indicated that the precise terms were to be kept confidential out of respect to Mr. Dean and so as to not unnecessarily upset members of the EUHS medical staff. He stated, though, that Mr. Dean's cash compensation was being set at the 95 th percentile of chief executives of large urban academic medical centers. Mr. Rome also indicated that he and Mr. Patterson had received a [reasonableness of compensation] opinion from an affiliate of Wade Wilson & Co, a nationally prominent human resources company which provides pension plan and related services to EUHS.

Mr. Rome also advised the Board of the understanding he had reached with Mr. Dean that Mr. Dean would be reimbursed for expenses incurred by he and his wife on a [first class] basis, in deference to the expectation that the Deans would essentially be working [24/7] for EUHS, and to Mr. Dean's expected significant fund raising duties.

In response to a question from Dr. Marcus, Mr. Rome stated that he would not ask the full EUHS Board to ratify the employment agreement, since it was too difficult to obtain a quorum for such a meeting and that EUHS needed Mr. Dean to begin his duties immediately. Without further question, and principally in reliance on their great trust and confidence in Mr. Rome's business acumen and devotion to EUHS, the Executive Committee unanimously ratified the Dean employment. Judge Smalls' firm was directed to prepare the necessary legal documents.

Nonprofit Governance Issues Associated with Act I

Δ The Exercise of Informed Business Judgment; The Business Judgment Rule and *Disney*

Δ The Limits of Authority of the Executive Committee

Δ Reasonableness of Executive Compensation/Qualifying for the [RPR]

Δ Compensation Consultant Independence

Δ Conflicts of Interest of Outside Legal Counsel

Δ Form 990 Compliance

Act II

Shortly after commencing his duties, Mr. Dean submitted a Conflicts of Interest Questionnaire disclosing the fact that he maintained a long term, intimate relationship with Ms. Dickerson. This was even though neither the Questionnaire nor the underlying Conflicts of Interest Policy required disclosure of material non-financial interests. Furthermore, Mr. Dean proposed to the Ethics and Conflicts Committee that he recuse himself from any influence in personnel decisions that might involve Ms. Dickerson, but that he not be barred from any [professional conduct] involving her.

Mr. Ono noted that the Ethics and Conflicts Committee did not wish to become involved in personnel matters. Accordingly, the Committee recommended that Ms. Dickerson be reassigned within the EUHS system to a position beyond the potential supervising influence of Mr. Dean. The Committee further recommended that she be given a favorable salary adjustment to compensate her from the fact that, due to the job transfer, she would no longer be eligible for the management level promotion for which she would have otherwise been a candidate had she remained as General Counsel. Mr. Ono directed Mr. Dean to work with Mr. Patterson to effect the job transfer and salary adjustment. Indeed, Mr. Dean directed Mr. Patterson to transfer Ms. Dickerson to the position of Compliance Officer of Eutheran Institute of Medical Research, a position from which she would not be under the direct supervision of Mr. Dean. Mr. Patterson strongly protested the request, but ultimately complied, given Mr. Dean's authority.

Mr. Ono advised the Executive Committee that the potential conflict of interest had been resolved. Mr. Dean subsequently replaced Ms. Dickerson with Ms. Veronica Badling, a recent graduate of The Bruce Springsteen College of Law. Mr. Dean justified his decision to the Executive Committee on the basis that the Office of General Counsel is not a revenue center and reminded the Committee that he was hired to achieve improved financial results for EUHS. He also pointed out that, do to Ms. Badling's law school training, she will certainly know [who is 'The Boss.']

Two months later, the Ethics Committee received an anonymous employee complaint (actually, from Mr. Patterson) about the Dickerson compensation. The Committee advised Mr. Dean of the complaint, concluding that the complaint raised no ethical issues. One month later, however, the complaint was published in the Daily Faberian newspaper.

Nonprofit Governance Issues Associated with Act II:

∆ Thoroughness of Conflicts of Interest Disclosure Questionnaire

∆ Effectiveness of Conflicts of Interest Review and Management Process

∆ Issues Associated with the [Appearance of Conflict of Interest]

∆ The Board's Obligation to Assure Appropriate Internal Legal Controls

∆ Duty of Confidentiality

Act III

Six months into his new position, Mr. Dean became greatly concerned with the risk that the EUHS credit rating would be downgraded due to declining financial conditions throughout the system. He attributed this problem principally to an historically unfavorable allocation of assets and resources throughout the system. Under the leadership of Dr. Marcus, EUHS had provided each of its three hospitals with financial and operational support based on community need, despite the fact that EUHS Metro operated annually with a substantial loss and was located in a community with rapidly declining demographics and other financial indicators. Mr. Dean was determined to reverse that practice and allocate system assets toward those strategies which would achieve the greatest financial results, with the hope that the credit rating could be stabilized and, if possible, upgraded.

Accordingly, Mr. Dean proposed to the Executive Committee a broad based financial and operational strategy which would, among other things: (a) increase the bed capacity at Heights through the construction of a new bed tower; (b) develop new [centers of excellence] at the Medical Center; (c) close an entire acute care wing at Metro (reducing capacity by 125 beds); (d) close the obstetrics/gynecology service at Metro, in order to concentrate system wide OB/GYN programs at a new Women's and Children's Hospital to be built on the Medical Center Campus; (e) implement a reduction in workforce at Metro at the nursing and management levels; and (e) terminate the implementation of previously board-approved plans to expand diagnostic and imaging services at Metro, which plans had also included the develop of several related ancillary facilities. EUHS would embark on a major capital campaign to support the related capital initiatives in the Dean strategy.

At the same meeting, Mr. Dean proposed a long term extension of the contract for debt collection services with the Genco affiliate, noting that it was achieving a 125% return, within a 3 day recovery period, on all hospital bills referred to it for collection. The Executive Committee approved this proposal without discussion.

With Mr. Rome's enthusiastic support, the EUHS Executive Committee approved Mr. Dean's strategic recommendations. Meeting immediately after the conclusion of the EUHS Executive Committee meeting, the same individuals met, this time acting in their capacity as members of the Executive Committees of Metro, Heights and of EUMC, to ratify the Dean strategy.

Subsequent to this meeting, several representatives of the full Metro Board (who were not members of the Executive Committee) challenged Mr. Rome and Mr. Dean concerning the wisdom of the strategy. These board members had been members of the Metro Board at the time of the 1997 affiliation with EUHS and were subsequently elected to the Metro Board pursuant to provisions in the underlying affiliation agreement mandating a certain percentage of board representation from the local community. These board members argued that the Dean strategy was inconsistent with the concept of community benefit and was limiting access to the Metro service area, contrary to the goals of the 1997 affiliation agreement. Mr. Rome and Mr. Dean argued that the actions were necessary to preserve and expand the system as a whole.

Two weeks later, the Metro board members filed a derivative-based action against the full board of Metro (including its Executive Committee) seeking to invalidate the Committee's ratification of the Dean strategy, and a separate action for breach of fiduciary duty against the members of the EUHS Executive Committee and EUHS itself.

Nonprofit Governance Issues Associated with Act III:

Δ Directors Serving as Corporate Vendors

Δ The Board's Duty of Obedience to Charitable Mission

Δ Fiduciary Duties Owed by Parent Corporations to Controlled Affiliates

Δ Conflicts of Interest Associated with Overlapping Directorships

Δ [Veil Piercing] and [Direct Participant] Theories of Corporate Liability Exposure

Δ Nonprofit Derivative Actions

Act IV

Eighteen months later, after the conclusion of a wildly successful capital campaign led by Mr. Dean, and the commencement of construction of the new bed tower and the Women's and Children's Hospital, an anonymous letter was delivered to every member of the EUHS board alleging a variety of expense report-related improprieties perpetrated by Mr. Dean and charging that his compensation was excessive. The letter contrasted these expense-related allegations against the declining level of services available at Metro. It detailed what it alleged were over $425,000 in personal expenses incurred by Mr. and Mrs. Dean which were improperly reimbursed by EUHS as business expenses, together with multiple violations of EUHS policy concerning the filing of expense reports and personal use of corporate property. Among the specific allegations were expenses attributed to a personal secretary and social planner for Mrs. Dean, a personal chef at the Dean residence (which was owned by EUHS), the use of the residence for a graduation party for the Dean's daughter while characterizing it as a business expense, thousands of dollars in limousine service, first class air fare and room reservations at five-star luxury hotels.

Several members of the full board of EUHS, led by Mr. Douglas, had long chafed at the autocratic leadership style of Mr. Rome and of the authority of the Executive Committee. They were deeply concerned by the allegations, their anonymous nature notwithstanding, and were successful in calling a special meeting of the EUHS Board, at which meeting a resolution for an independent investigation into the allegations by outside counsel was approved. Mr. Rome assigned the Smalls Law Firm, under the direction of Mr. Perry, to conduct the investigation. Mr. Rome dismissed suggestions that the Smalls Firm lacked the requisite level of experience and independence, noting the efficiencies associated with its great familiarity with EUHS.

After extensive review lasting over one month, the highly confidential [Perry Report] concluded that Mr. Dean had (a) improperly characterized personal expenses as business related, (b) failed to submit appropriate travel expense reports in a manner consistent with EUHS Policy, and (c) understated his personal income on state and federal income tax returns, and (d) that Mr. Dean had violated his fiduciary duty to the corporation by failing to cooperate with the efforts of the Executive Compensation Committee to qualify his compensation for the rebuttable presumption of reasonableness.

Calling a meeting of the full board of directors to address these issues, Mr. Dean characterized all of the expenses as consistent with the [24/7] approach he and his wife took with respect to their EUHS obligations. Mr. Dean also noted that the significant travel, lodging and entertainment expenses were necessary in order for him to solicit the types of capital contributions which ultimately proved so necessary to the success of the capital campaign. He acknowledged that his expense report records were incomplete, but reminded the board that EUHS policy was to destroy corporate travel and related expense records after six months. He offered to reimburse EUHS for any errors in his record keeping and to file amended tax returns where necessary. Mr. Rome (accompanied by his personal lawyer, Thomas Hagen) advised the Board of the provisions of the Dean employment agreement which anticipated this level of commitment from Mr. Dean and which called for expense reimbursement at [first class] levels.

Mr. Douglas and his supporters on the board expressed outrage that the terms of the Dean employment agreement had never been brought before the full board. They demanded the resignations of both Mr. Rome and Mr. Dean. The day after the meeting, the Perry Report was reprinted in its entirety in the Daily Faberian.

Nonprofit Governance Issues Associated with Act IV:

Δ Obligations and Liabilities of Non-Executive Committee Members in Bifurcated Governing Board

Δ Reasonableness of Discretionary Expenses of CEO

Δ Duty of Care/Oversight Obligations of Board

Δ Reasonableness of Treating Spousal Expenses as Business-Related

Δ The Role of the Entire Board in Approving Executive Compensation Arrangements

Δ [Independence] of Counsel in Conducting Internal Reviews and Investigations

Δ The Fiduciary Duty of Confidentiality

EPILOGUE

Two weeks after the publication date, EUHS, Mr. Rome and Mr. Dean were requested to appear before the Senate Finance Committee, as part of the Committee's ongoing investigation of abuse in the nonprofit sector. An audit of EUHS was subsequently initiated by the IRS. Mr. Dean negotiated a settlement of his employment agreement, and Mr. Rome resigned from the board, in order to assume greater ownership and operational involvement in the business enterprises of Genco Oil Company.

All of the characters used in this hypothetical fact pattern are strictly fictitious. Any resemblance to an actual individual, living or deceased, is strictly unintentional.

By Health Lawyers • for Health Lawyers

IRS [Good Goverance] Practices Analysis and Annotations

by MICHAEL W. PEREGRINE, ESQUIRE ELIZABETH M. MILLS, ESQUIRE

HEALTH LAWYERS: TOPICAL INSIGHT SERIES

AMERICAN **HEALTH LAWYERS** ASSOCIATION

The Internal Revenue Service ([IRS]) recently released proposed, suggested governance guidelines for organizations recognized as tax-exempt under IRC Section 501(c)(3), such as hospitals and health systems ([Proposed Guidelines]). [FN 1] Satisfaction of the Proposed Guidelines is not a requirement for exemption, but they are intended to emphasize what the IRS believes to be the important relationship between effective governance and satisfaction of exempt purposes.

The Proposed Guidelines address the following nine general topics: (1) adoption of a mission statement; (2) adoption of a code of ethics and whistleblower policies; (3) satisfaction of the duty of care/director diligence; (4) satisfaction of the duty of loyalty/effective conflicts of interest oversight; (5) constituent transparency; (6) oversight of fundraising activity; (7) stewardship of financial affairs; (8) payment of reasonable compensation; and (9) adoption of a document retention policy.

According to senior IRS official Marvin R. Friedlander,[FN 2] the IRS does not have authority to require that exempt organizations adopt the Proposed Guidelines.[FN 3] Rather, it is the IRS' hope that the Proposed Guidelines will help directors of exempt organizations [understand their roles and responsibilities and actively promote good governance practices.][FN 4] Indeed, the historical IRS perspective is that there is a relationship between effective corporate governance practices and satisfaction of the [community benefit] standard of tax exemption. In recent published comments, IRS Commissioner (Tax Exempt and Government Entities) Steven T. Miller called promotion of good governance a new [pillar] of the IRS' service and enforcement programs for exempt organizations.[FN 5]

[t]he issue of governance is relevant to any discussion of exempt organizations because a well-governed organization is more likely to be compliant; while poor governance can easily lead an organization into trouble.[FN 6]

Indeed, the IRS statement of the [community benefit] standard, Revenue Rule 69-545,[FN 7] notes that the hospital in the [good] fact pattern has a board made up of prominent citizens in the community.[FN 8] Both Sen. Charles Grassley and IRS Commissioner Everson have made repeated public comments to the effect that an [independent, empowered and active board of directors is a critical component of assuring that a tax-exempt corporation serves public purposes and protects charitable assets.][FN 9] Conversely, [poor governance is a factor that unites all charities found to have failed their mission.] [FN 10] The Compliance Check Questionnaire issued to approximately 550 hospitals in 2006 by the IRS included a series of questions relating to the organization's governance practices, and the newly revised Application for Recognition of Exemption as a Under Section 501(c)(3) of the Internal Revenue Code ([Form 1023]), requires extensive information about board composition and conflict of interest policies.

As Mr. Miller has clearly stated, the IRS expects to ‘fill the vacuum’ created by the absence of a federal counterpart to the governance oversight role of state charity officials.[FN 11]

The following is an analysis of the nine specific governance guidelines proposed by the IRS:

Good Governance Practices for 501(c)(3) Organizations

The Internal Revenue Service believes that governing boards should be composed of persons who are informed and active in overseeing a charity's operations and finances. If a governing board tolerates a climate of secrecy or neglect, charitable assets are more likely to be used to advance an impermissible private interest. Successful governing boards include individuals not only knowledgeable and passionate about the organization's programs, but also those with expertise in critical areas involving accounting, finance, compensation, and ethics.

Organizations with very small or very large governing boards may be problematic: Small boards generally do not represent a public interest and large boards may be less attentive to oversight duties. If an organization's governing board is very large, it may want to establish an executive committee with delegated responsibilities or establish advisory committees.

The Internal Revenue Service suggests that organizations review and consider the following to help ensure that directors understand their roles and responsibilities and actively promote good governance practices. While adopting a particular practice is not a requirement for exemption, we believe that an organization that adopts some or all of these practices is mere likely to be successful in pursuing its exempt purposes and earning public support.

Mission Statement

Code of Ethics

Due Diligence

Duty of Loyalty

Transparency

Fundraising Policy

Financial Audits

Compensation Practices

Document Retention Policy

1. Mission Statement

A clearly articulated mission statement that is adopted by an organization's board of directors will explain and popularize the charity's purpose and serve as a guide to the organization's work. A well-written mission statement shows why the charity exists, what it hopes to accomplish, and what activities it will undertake, where, and for whom.

2. Code of Ethics and Whistleblower Policies

The public expects a charity to abide by ethical standards that promote the public good. The board of directors bears the ultimate responsibility for setting ethical standards and ensuring they permeate the organization and inform its practices. To that end, the board should consider adopting and regularly evaluating a code of ethics that describes behavior it wants to encourage and behavior it wants to discourage. The code of ethics should be a principal means of communicating to all personnel a strong culture of legal compliance and ethical integrity.

The board of directors should adopt an effective policy for handling employee complaints and establish procedures for employees to report in confidence suspected financial impropriety or misuse of the charity's resources. Such policies are sometimes referred to as *whistleblower* policies.

3. Due Diligence

The directors of a charity must exercise due diligence consistent with a duty of care that requires a director to act:

Δ In good faith;

Δ With the care an ordinarily prudent person in a like position would exercise under similar circumstances;

Δ In a manner the director reasonably believes to be in the charity's best interests.

Δ Directors should see to it that policies and procedures are in place to help them meet their duty of care. Such policies and procedures should ensure that each director:

Δ Is familiar with the charity's activities and knows whether those activities promote the charity's mission and achieve its goals;

Δ Is fully informed about the charity's financial status; and

Δ Has full and accurate information to make informed decisions.

Δ 4. Duty of Loyalty

Δ The directors of a charity owe it a duty of loyalty. The duty of loyalty requires a director to act in the interest of the charity rather than in the personal interest of the director or some other person or organization. In particular, the duty of loyalty requires a director to avoid conflicts of interest that are detrimental to the charity. To that end, the board of directors should adopt and regularly evaluate an effective conflict of interest policy that:

Δ Requires directors and staff to act solely in the interests of the charity without regard for personal interests;

Δ Includes written procedures for determining whether a relationship, financial interest, or business affiliation results in a conflict of interest; and

Δ Prescribes a certain course of action in the event a conflict of interest is identified.

Δ Directors and staff should be required to disclose annually in writing any known financial interest that the individual, or a member of the individual's family, has in any business entity that transacts business with the charity. Instructions to Form 1023 contain a sample conflict of interest policy.

Δ 5. Transparency

Δ By making full and accurate information about its mission, activities, and finances publicly available, a charity demonstrates transparency. The board of directors should adopt and monitor procedures to ensure that the charity's Form 990, annual reports, and financial statements are complete and accurate, are posted on the organization's public website, and are made available to the public upon request.

Δ 6. Fundraising Policy

Δ Charitable fundraising is an important source of financial support for many charities. Success at fundraising requires care and honesty. The board of directors should adopt and monitor policies to ensure that fundraising solicitations meet federal and state law requirements and solicitation materials are accurate, truthful, and candid. Charities should keep their fundraising costs reasonable. In selecting paid fundraisers, a charity should use those that are registered with the state and that can provide good references. Performance of professional fundraisers should be continuously monitored.

Δ 7. Financial Audits

Δ Directors must be good stewards of a charity's financial resources. A charity should operate in accordance with an annual budget approved by the board of directors. The board should ensure that financial resources are used to further charitable purpose by regularly receiving and reading up-to-date financial statements including Form 990, auditor's letters, and finance and audit committee reports.

Δ If the charity has substantial assets or annual revenue, its board of directors should ensure that an independent auditor conduct an annual audit. The board can establish an independent audit committee to select and oversee the independent auditor. The auditing firm should be changed periodically (e.g., every, five years) to ensure a fresh look at the financial statements.

Δ For a charity with lesser assets or annual revenue, the board should ensure that an independent certified public accountant conduct an annual audit.

Δ Substitute practices for very small organizations would include volunteers who would review financial information and practices. Trading volunteers between similarly situated organizations who would perform these tasks would also help maintain financial integrity without being too costly.

Δ 8. Compensation Practices

Δ A successful charity pays no more than reasonable compensation for services rendered. Charities should generally not compensate persons for service on the board of directors except to reimburse direct expenses of such service. Director compensation should be allowed only when determined appropriate by a committee composed of persons who are not compensated by the charity and have no financial interest in the determination.

Δ Charities may pay reasonable compensation for services provided by officers and staff. In determining reasonable compensation, a charity may wish to rely on the rebuttable presumption test of section 4958 of the Internal Revenue Code and Treasury Regulation section 53.4958-6.

Δ 9. Document Retention Policy

Δ An effective charity will adopt a written policy establishing standards for document integrity, retention, and destruction. The document retention policy should include guidelines for handling electronic files. The policy should cover backup procedures, archiving of documents, and regular check-ups of the reliability of the system. For more information see IRS Publication 4221, *Compliance Guide for 501(c)(3) Tax-Exempt Organizations*, available on the IRS website.

BNA's

HEALTH LAW REPORTER

Corporate Governance

Breaking Up Isn't Hard to Do: *Health Alliance* and Health System Structuring

By Michael W. Peregrine and James R. Schwartz

Despite its unique facts, the April 16 decision in the closely watched *Health Alliance* case[FN 1] has potentially significant implications for nonprofit health systems formed through joint operating agreement, change of membership/affiliation, or similar means. This judicially sanctioned withdrawal of two parties to a joint operating agreement (JOA) could create increased instability in those systems where tension among corporate parties already has arisen. This is particularly the case where the underlying system agreements are loosely drawn, or provide some basis for a party's withdrawal or disaffiliation.

Of particular interest-and potentially greater importance than the court's findings with respect to the rights of the parties under the specific JOA in question-is the court's conclusion that [parent]-type organizations owe fiduciary duties to their independent nonprofit affiliates. This conclusion eventually could have far-reaching implications for the organization, operation and control of nonprofit health systems. Attentive health systems and their counsel may wish to consider the obligations such a judicially recognized relationship creates on the part of [parent] organizations-and the risks it engenders with respect to both monetary liability and with respect to equitable remedies related to operational and governance controls in the traditional parent/affiliate organizational structure. Moreover, the obvious question is, assuming the existence of such a fiduciary relationship and the obligations it entails, whether the benefits of a JOA (or similar) structure outweigh the potential benefits provided by alternative models-including a single corporation model.

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I. *Brief Case Overview*

The basis for the litigation was an action filed by the Health Alliance, a $1.4 billion joint operating company (JOC), to prevent corporate affiliates Christ Hospital and St. Luke's Hospital from withdrawing from the nonprofit system which had been the largest health care network in the Greater Cincinnati/Northern Kentucky region.[FN 2] Christ Hospital and St. Luke's subsequently filed counterclaims to seek court confirmation of their right to withdraw, and the Ohio attorney general intervened in the case to protect the public interest with respect to the charitable assets involved. After a lengthy trial, Judge Fred Nelson of the Hamilton County (Ohio) Court of Common Pleas ruled that the two hospitals were entitled to end their participation in Health Alliance pursuant to the provisions of the underlying joint operating agreement. The court also found a separate basis for withdrawal in Health Alliance's breach of the fiduciary duty it owed to the hospitals.

A. *Right to Withdraw*

Much attention has been focused on the provision in the underlying joint operating agreement that authorized a [Participating Entity] to withdraw upon an uncured event of default. However, the significance of this withdrawal right must be viewed in the context of two other key terms: (a) the right of the [Participating Entities,] through their respective boards, to [continue to exercise ultimate responsibility for fulfilling their respective charitable missions and obligations][FN 3] and (b) the obligation of Health Alliance (the JOC) to [at all times operate the Alliance consistent with the charitable missions of the participating entities.][FN 4]

The controversy was prompted by independent decisions, first by Christ Hospital and subsequently by St. Luke's Hospital, to declare an event of default and withdraw from the JOA. Health Alliance actually initiated the litigation by its request for a declaration that [there were no pending circumstances] that would allow Christ Hospital and St. Luke's Hospitals to withdraw.

The court concluded that both Christ and St. Luke's Hospital had [manifestly] established their respective rights to terminate their Health Alliance relationships through their good faith determination that the Health Alliance relationship had impeded pursuit of the hospitals' charitable missions. Applying a [business judgment rule] analysis, the Court concluded that the independent withdrawal decisions were effected with [due care,] and not a pretext (as Health Alliance had argued). For example, Christ Hospital's decision to withdraw was based upon multiple mission-based reasons, including concerns that: (a) Christ Hospital had been [under funded within the Alliance structure]; (b) programming and funding arrangements were subordinated to the University of Cincinnati (another participating entity); (c) Christ Hospital had failed to realize benefits originally envisioned from Alliance participation; and (d) Alliance had adopted an adversarial position with respect to Christ Hospital.[FN 5]

B. *Breach of Fiduciary Duty*

The court also concluded that Health Alliance breached its fiduciary duties to the two hospitals, thus providing further grounds for their withdrawal from the JOA relationship. Specifically, the court found that the nature of the joint operating arrangement created the very kind of special relationship of [trust and confidence] that establishes a fiduciary relationship.[FN 6] Particular *indicia* of this [special relationship] included Alliance's responsibility to: (a) manage the affairs of the participating entities; (b) hold the assets of the participating entities; (c) collect and allocate all revenues of the participating entities; (d) maintain the business records of the participating entities; (e) employ the operational staff of the participating entities; and (f) [‘at all times operate … consistent with the charitable missions of … the Participating Entities,’ among other responsibilities.][FN 7] Other JOA features deemed to establish a fiduciary relationship included the fact that the [Participating entities … surrendered to the Alliance all control over their revenue streams, are precluded from incurring debt, do not control their assets, and do not hire or manage their own staff …][FN 8] From the court's perspective, it was the combination of these *indicia* and features, coupled with the [resulting imbalance of resources,] that created the fiduciary relationship. [FN 9]

The breach of these duties was found to arise from both operational actions taken by Alliance, as well as specific steps it took associated with the litigation. According to the court, specific breaches included Alliance's (a) initiation of the subject litigation without notice and in contravention to the contractually required resolution period; (b) use of JOA funds to pursue the litigation while denying Christ Hospital and St. Luke's Hospital access to their own revenues to fund their defense; (c) action during the course of the litigation to bind Christ Hospital and St. Luke's Hospital, without their consent, to over $200 million in additional Master Trust Indenture bond obligations; and (d) use of its [superior position] to constrain, by a variety of means, Christ Hospital's ability to compete in the future.

II. *Analysis*

In evaluating the significance of *Health Alliance,* it should be recognized that while many aspects of the court's decision are fact-specific to this particular joint operating agreement, certain other aspects of the decision have broader application to nonprofit health systems. Taken collectively, however, they create new corporate law challenges that some traditional nonprofit health systems may find difficult to meet.

A. *Fact-Specific Considerations*

1. The court's perspective was clearly that the terms and conditions of this particular joint operating agreement preserved autonomy for the participating entities. Most relevant in this regard were specific protections for the participating entities to protect their charitable mission; valid withdrawal rights; and testimony/ documentary evidence that the JOA was recognized as a [limited confederation model] that anticipated the potential for withdrawal.

2. The Health Alliance JOA ultimately appears to have suffered from the absence of specific provisions in the articles and bylaws of the participating entities providing for a common charitable mission and system-wide obligations. Indeed, the court observed that [the language of the JOA suggests separate mission determinations by the separate participating entities and nowhere requires that each subscribe to one uniform charitable mission.][FN 10] It was this factor that the court relied on to support the right of each participating entity to separately determine what was required to fulfill its own charitable mission and to justify withdrawal based on its independent determination that Alliance was not operating in a manner consistent with such mission(s).

3. For whatever reason (terms of the JOA, client demands, etc.), several of Health Alliance's actions and subsequent litigation arguments appear to have been counterproductive. For example, both the court-and the attorney general-vigorously rejected the argument that the governance authority of the boards of directors of the participating entities were, by the terminology in the JOA, [passive] rather than [active.] Indeed, because most state nonprofit laws expressly require that the governing board exercise ultimate authority over the corporation, to argue that a board's fiduciary duties are [passive] (*i.e.*, less than full) seems almost certain to be rejected as a matter of law.

4. A linchpin of the court's analysis was the application of the business judgment rule to evaluate the boards' determination of the charitable mission of their respective organizations. While the business judgment rule normally is applicable to decisions of boards of directors of nonprofit organizations, the determination of the specific charitable purpose of an entity (in the context of litigation over the nature and extent of that purpose) most often has been treated by the courts as a legal issue to be determined by the court, after considering the articles of incorporation, bylaws, donative instruments and historical operations of the organization-and not one subject to the same deference as for normal business decisions.

5. The language and tone of the written decision strongly reflects substantial irritation by the court with Health Alliance's technical approach to the controversy, including the manner in which it initiated the litigation ([the race to the courthouse does not always benefit the swift]).

B. ***Broader Considerations***

1. The important part of the decision-from a broader health system perspective-is its discussion of fiduciary duties. The court's definition of the type of [special relationship] creating a [fiduciary relationship] is well-stated, and transcends not only the unique facts of this case but also the particular structural characteristics of a JOA. Where a joint operating company-or a parent company in a [holding company] model-acts in a manner that is adverse to one or more of its affiliates (and the corporate documents do not expressly provided for an agreed upon primacy of system purposes) the *Health Alliance* decision provides a basis for breach of fiduciary duty exposure. This potential for breach could be increased where there are [overlapping] boards between the parent and its affiliates. An open question remains, though, as to how much [primacy] for the system-wide purposes an affiliate board may [cede] without violating its own fiduciary duties set forth under its own articles of incorporation. Moreover, the authors note that significant legal issues may arise if a JOA were to contain provisions that might be interpreted to abandon the historical dominant purpose of a formerly independent hospital-particularly if there were geographic, beneficiary class, or other restrictions in the hospital's governance documents or in relevant donative instruments.

2. In the negotiation and documentation of any major corporate transaction, there is tension between the benefits of detail and the natural attraction of [getting the deal done.] Where these two concepts are not properly balanced, there exists significant risk of a failure to have a meeting of the minds on critical issues. In *Health Alliance,* there appears to have been a fundamental disagreement on the fiber and character of the relationship-whether it was to be a [virtual merger] (Health Alliance) or a loose confederation permitting more individualized determination (Christ Hospital, St. Luke's Hospital and the attorney general).

It is, thus, a significant reminder that structural/control accommodations in the negotiation of system structuring can have a haunting effect.

3. The active intervention of the Ohio attorney general on behalf of Christ Hospital and St. Luke's Hospital was to be expected and is entirely consistent with the traditional perspective of state charity officials on fiduciary duties. Nonprofit health systems and related organizations encountering similar controversies in other states should thus anticipate the close scrutiny, and potentially the involvement, of state charity officials.

III. ***Conclusions, Recommendations***

It should be emphasized that *Health* Alliance is a trial court decision and is subject to appeal. It also should be emphasized that the case is based on a unique set of facts (*i.e.*, the specific terms of the JOA). Nevertheless, the decision has potentially broad implications for the formation and administration of nonprofit health systems. System-type organizational structures that involve parent organizations seeking to control independent nonprofit affiliates (which have their own [legal] governing boards and separate definitions of charitable mission) are increasingly subject to institutional conflicts of interest.

The potential for disputes of this kind merits a review of the continued effectiveness for the established organizational model of a parent [supporting] organization that maintains control over independently incorporated affiliates, whether through' contractual arrangements (*e.g.*, a JOA), reserved powers and/or overlapping board memberships. There can be little argument that this model was developed for sound reasons and has long served as an effective and responsive governance structure. However, as health systems are increasingly being subject to intra-system and external control challenges, they may wish to revisit the continued effectiveness of this model. Indeed, [single corporate] models (while not without their own legal [hurdles]) may offer more efficiencies, greater control, and less vulnerability to these types of challenges.

[FN 1]The Proposed Guidelines were distributed on February 2, 2007 at the Joint Annual Meeting of the Gulf Const., Great Lakes and Mid-Atlantic Areas TE/GE Council, held in Washington, DC and are available on the IRS website at *http://www.ir.gov/pub/irs-tege/good_governance_practices.pdf*

[FN 2]Chief, Exempt Organizations Technical Branch, Office of Rulings and Agreements.

[FN 3]BNA's Healthcare Daily, Vol. 12, No. 23, 2/5/07.

[FN 4]*Id.*

[FN 5][IRS Official Speaks on Exempt Organization Issues] Tax Notes (Tax Analysts), May 1, 2007.

[FN 6]*Id.*

[FN 7]1969-2 C.B. 117.

[FN 8]A strict IRS position on board composition for health care organizations generally limiting physicians to 20 percent of the board was articulated in training materials in 1993. Chapter N, [Integrated Delivery Systems,] in 1994 Exempt Organizations Continuing Professional Education Test (published in August 1993). In 1996, this position was relaxed somewhat but emphasis placed on conflict of interest policies for heath care organizations. Chapter C, [Tax-Exempt Health Care Organizations Community Board and Conflicts of Interest Policy,] in FY 1997 Exempt Organizations Continuing Professional Education Text (published in August 1996).

[FN 9]Letter to IRS Commissioner Mark W. Everson to Senator Charles E. Grassley, March 30, 2005 (p. 3) (*http://finance.senate.gov/hearings/other/Letter-from-Everson.pdf*) ([Everson Letter]).

[FN 10]Memorandum, U.S. Senate Committee on Finance, Senator Charles E. Grassley, of Iowa, Chairman, Friday, July 28, 2006, [GAO Survey on nonprofit hospitals-executive compensation] ([Grassley July 28, 2006 Memorandum]) (*http://finance.senate.gov*).

[FN 11]F.n. 5, *supra*.

[FN 1] *Health Alliance of Greater Cincinnati v. Christ Hospital*, Ohio Ct. Com. Pl., No. A0601969, April 16, 2007.

[FN 2]Cliff Peale and Peggy O'Farrell, [Judge Lets Christ, St. Luke Quit Health Alliance,] *The Cincinnati Enquirer,* April 17, 2007.

[FN 3]Decision, p. 3.

[FN 4]*Id*.

[FN 5]*Id.,* p. 9-10.

[FN 6][The term 'fiduciary relationship' has been defined as a relationship in which special confidence and trust is reposed in the integrity and fidelity of another and there is a resulting position of superiority or influence, acquired by virtue of this special trust.] *Health Alliance, supra,* p. 20, citing *Groeb v. Keybank* (2006), 108 Ohio St. 3d 348, 351.

[FN 7]Decision, p. 20-22.

[FN 8]*Id.*

[FN 9]*Id.*

[FN 10]Decision, p. 4.

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