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## Corporate Governance

### Key Nonprofit Corporate Law Developments in 2009

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The year 2009 witnessed an extraordinary series of developments in nonprofit corporate and charitable trust law as they affect the governance and operation of hospitals and health care systems. This is consistent with a decade-long trend that has made corporate law and governance key legal feasibility considerations for nonprofit organizations.

These developments reflect the following general trends: (a) increased oversight from state and federal charity regulators; (b) greater focus on corporate governance practices; (c) closer scrutiny of the exercise of business judgment by boards; (d) the evolution of system structures and business combinations; and notably, (e) the governance implications of a recessionary economy.

Based on these trends, our "top ten" list of major nonprofit developments for health care providers in 2009 is as follows:

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#### 1. Governance Under Stress.

The "Great Recession" of 2008-2009 had a dramatic effect on the governing board oversight of nonprofit financial affairs. During this period, nonprofit hospitals and health systems suffered through a "parade of (financial) horrors": significant negative outcomes in financial performance, a marked downturn in charitable giving, widespread reductions in workforce, an uncertain recovery timetable, and increased financial-related challenges. Particular financial challenges included organizational solvency, debt covenant compliance, the security of the investment portfolio, proper revenue/expense management, the potential need to consider reorganization/bankruptcy options, and the concern of third parties such as creditors, donors and charity regulators.

These unique financial concerns prompted a series of related governance challenges at both the full board and the finance committee levels. Included were issues with respect to the intensity of board oversight of financial affairs, the adequacy of board and committee "skill sets," the level of finance-related information flow to the board and relevant committees, the accessibility of the chief financial officer and financial administration staff to the board and to key committees, and the effectiveness of audit committee practices.

The importance of the board's financial oversight role was addressed in a series of reports issued throughout 2009 by Moody's Investor Services, a prominent health industry rating agency which incorporates

governance criteria in its rating analysis. For example, in its April, 2009, report, Moody's commented favorably on the contributions toward financial stability that the nonprofit governing board can make when it works in close consultation with the executive management team on financial matters.<sup>1</sup> The lessons of the financial downturn also have prompted a broader interest in improving the risk oversight by the board in general, and enhancing the effectiveness of the audit committee in particular. Improved financial risk oversight practices were recommended in position papers prepared by two separate, prominent business policy organizations.<sup>2</sup> While much of the impetus for this interest comes from the public company sector, the recommendations and guidelines it produces will no doubt have a spillover impact on the nonprofit sector.

The IRS also contributed in 2009 to the discourse on the proper financial oversight role of the nonprofit board. In its December, 2009, governance examination guidelines,<sup>3</sup> the IRS alerts its agents to a series of financial oversight "red flags." These include: (a) failure to provide board members with written financial reports; (b) failure of the board to consider and discuss these financial reports; (c) the independent auditor's report is not discussed by the full board or by a committee; and (d) neither the full board nor a committee thereof reviews and acts upon the comments and observations contained in the auditor's "management letter."

The relationship between effective governance and a strong bond rating—particularly in times of crisis—also was referenced in a November, 2009, release from Moody's.<sup>4</sup> This particular report underscored the value of the board questioning management strategies and holding management accountable.

## 2. Fiduciary Duties.

2009 included a disparate set of judicial enforcement developments affecting the application of fiduciary duties to directors and officers of nonprofit corporations. Of particular significance to nonprofit directors was the Sept. 17, 2009, action by the New Jersey attorney general to file a sweeping 16-count civil action against the nonprofit Stevens Institute of Technology and its president and board chair.<sup>5</sup> The central allegations related to financial mismanagement, misuse of endowment assets, and excessive executive compensation.

The specific charges alleged a broad cross-section of nonprofit law/Uniform Management of Institutional Funds Act (UMIFA) violations. Further, they were spread among the board chair (e.g., failure to monitor, awarding ultra vires loans, awarding excessive compen-

sation, misuse of endowment assets); all of the defendants (failure to maintain books, records, and accounts; breach of the duty of obedience); the president (grossly negligent spending, borrowing, and financial management; breach of UMIFA duties; receipt of excessive compensation); certain "insider" defendants (breaches of the duties of candor, loyalty, and good faith; aiding and abetting breach of fiduciary duty); and the president and the corporation (mismanagement and misuse of charitable trusts restricted assets).

The scope of relief sought by the complaint was also notable. The state sought certain declarations of breach of duty and misconduct, to compel a corporate accounting, the repayment of certain payments, to impose a constructive trust on the president, requiring the president to pay restitution, enjoining the forgiveness of ultra vires loans, directing the corporation to reform its internal controls and accounting practices, and removing certain board members.

Separately, several notable Delaware decisions promise to have a "spillover" effect on the nonprofit sector.<sup>6</sup> For example, a Jan. 27 decision of the Delaware Supreme Court in *Gantler v. Stephens* expressly found (as a matter of first impression) that corporate officers owe the same fiduciary duties of care and loyalty to the corporation (and its stockholders) as are owed by the corporation's directors.<sup>7</sup> The decision arose in the context of a shareholder derivative suit, alleging breach of fiduciary duty on behalf of a stock corporation's officers and its directors. The subject conduct arose from the board's decision to abandon a merger bidding process and its subsequent decision to privatize its assets. The plaintiffs' argument was that the decision to abandon the merger/sale process and pursue privatization was made for the benefit of the officers and board. The Delaware Chancery Court had dismissed the shareholders' complaint. However, the Supreme Court reversed the dismissal, concluding that the complaint sufficiently presented claims for breach of duty. In particular, the Supreme Court found merit in the plaintiff's allegations that the corporate officers had undermined the due diligence portion of the bidding process in order to preserve certain personal interests and benefits that would have been lost had a sale been consummated (e.g., their positions, pay, and the ability to leverage their corporate positions with outside business relationships). By their pleadings, the claims adequately presented a claim that the officers acted in a disloyal manner with respect to the corporation. As a result of the *Gantler* decision, some observers expect an increase in litigation personally identifying corporate officers for breach of fiduciary duty (at least, initially, in the Delaware Courts).<sup>8</sup>

<sup>1</sup> Moody's Investor Services Special Comment, "Not-for-Profit Healthcare Rating Roadmap: Hospitals Under Stress, but Strong Management and Federal Stimulus May Mitigate Risks" (April, 2009).

<sup>2</sup> See, e.g., National Association of Corporate Directors Press Release (11/30/09), "NACD Convenes First-Annual Audit Committee Chairman's Forum"; The Conference Board, "Adapting to Regulatory Developments and Emerging Practices" (November, 2009).

<sup>3</sup> <http://www.irs.gov/charities/article/0,,id=216068,00.html>.

<sup>4</sup> Moody's Investors Service Special Comment, "Diagnosing Not-for-Profit Hospital Upgrades" (November, 2009).

<sup>5</sup> <http://www.nj.gov/oag/newsreleases09/pr20090917a-complaint.pdf>; the case was settled by a final consent judgment dated Jan. 15, 2009 (<http://www.nj.gov/oag/newsreleases10/pr20100115b.html>).

<sup>6</sup> Delaware cases are worthy of note by nonprofit corporations because of the number of businesses incorporated in Delaware, the volume of business controversies litigated in Delaware courts, the strength of its judiciary (including a specialized court, the chancery court, that has jurisdiction over cases arising under its corporate laws), and the fact that it has a unified corporation code applicable to for-profit and nonprofit corporations alike. Furthermore, Delaware decisions often address alleged violations of fiduciary duty that closely resemble those duties owed by directors of nonprofit corporations.

<sup>7</sup> *Gantler v. Stephens*, No. 132-2008, 2009 Del. LEXIS 33 (Del. Jan. 27, 2009).

<sup>8</sup> 7 CARE 1253 (10/26/09).

A Feb. 24 decision of the Delaware Chancery Court, *In re Citigroup*, addressed the limits of business judgment rule protection.<sup>9</sup> The case involved a shareholder derivative claim alleging that the Citigroup board breached its fiduciary duties by authorizing corporate investments in the subprime mortgage market, which ultimately led to huge losses. The specific claim was that the board acted in bad faith by failing to see the warning signs of deterioration in the subprime market and failing to cause Citigroup to change its investment policy to limit its subprime exposure. In other words, the principal issue presented was whether the pleading set forth facts sufficient to present board members with a realistic likelihood of personal liability.

The Chancery Court granted a motion to dismiss the claim, holding that the plaintiffs failed to adequately plead a (bad faith based) claim for oversight liability; i.e., facts which would have demonstrated that the Citigroup board “consciously disregarded an obligation to be reasonably informed about the business and its risk or consciously disregarded the duty to monitor or oversee the business.” Significantly, the court observed that worsening market conditions (and concerns for further deterioration) were not enough to overcome the protection of the business judgment rule.

*Citigroup* offers strong support for business judgment rule protection to investment and other business risk decisions which lead to catastrophic corporate loss. However, the unique nature of the charitable, nonprofit corporation is such that state charity officials may feel compelled to scrutinize director conduct with respect to business risk decisions (e.g., imprudent investments) which lead to substantial losses for the nonprofit corporation. Specific state laws (e.g., nonprofit corporation law, Uniform Prudent Management of Institutional Funds Act (UPMIFA) or UMIFA), donor restrictions, and/or internal investment standards also may have an impact and may create a stricter standard than is applicable in the for-profit corporation setting.

### 3. IRS Scrutiny.

The IRS continued in 2009 its close focus of recent years on the corporate governance of nonprofit, tax exempt organizations. This focus was particularly manifested through speeches by IRS officials, release of governance related guidelines and training material, large case audits and examinations and similar efforts. Indeed, the IRS’ commitment to its nonprofit governance initiative appears certain to continue with the midsummer appointment of Laura Hall Ingram (succeeding Steven Miller) as commissioner of the Exempt Organization Division.

In a June 23, 2009 speech, Commissioner Ingram reiterated the theme so often associated with former Commissioner Miller—that the IRS is committed to asserting its (implied) jurisdiction over nonprofit governance because of the perceived link between good governance and tax compliance.<sup>10</sup> In her comments, Commissioner Ingram stated that the IRS would begin gathering objective governance data in the course of its

“EO” examinations, principally for the purpose of ultimately sharing the data with the public. Commissioner Ingram also pledged to be transparent with respect to the process and materials the IRS uses in training its agents on governance matters, and the specific governance questions it applies in the course of examinations.

Indeed, on July 23, 2009, the IRS released new materials it uses to train its agents on “EO” governance issues.<sup>11</sup> The training materials consisted of a combination of outlines and PowerPoint presentations intended to (a) provide context within which nonprofit governance has become such an important area of IRS focus; (b) describe the various governance-related roles of the IRS, state charity officials, and the nonprofit sector itself; (c) emphasize those governance practices the IRS encourages organizations to adopt; and (d) discuss the role of individual IRS personnel as it relates to their review of governance issues. The materials for examinations and headquarters personnel focused on Form 990 questions addressing governance, while the materials for determination staff focused on Form 1023 questions involving governance.

Then, on Dec. 9, the IRS released an informative set of guidelines to be applied by its agents in the course of evaluating the governance of tax exempt organizations under examination.<sup>12</sup> The guidelines include both a “Governance Check Sheet” to be compiled by the examining agent, and a supplementary “Guide Sheet” to be used when completing the check sheet. The new examination guidelines expand upon the governance topics addressed in Part VI of the Form 990 by highlighting those practices likely to be viewed with the suspicion or concern by the IRS.

The check sheet contains a total of 28 questions, broken down into seven sections, six of them substantive: “Governing Body and Management,” “Compensation,” “Organizational Control,” “Conflict of Interest,” “Financial Oversight,” and “Document Retention.” The check sheet was designed as an “on line” application, incorporating “drop down” menus of possible responses without much room to accommodate a narrative response or other description. The guide sheet was intended as a reference to the IRS agent in completing the check sheet as it relates to the governance portion of the examination. It contains 28 supplemental “prompts” which correspond to the individual questions on the check sheet. The guide sheet is more descriptive than the check sheet, contains several specific examples and in general is a more valuable resource for both the IRS agent—and the EO counsel.

The IRS stated that it will use the check sheet information as part of a long term study it has undertaken to gain a greater awareness of the relationship between charity tax compliance and effective governance practices. There is no current indication that the IRS intends to elevate improper governance practices (in and of themselves) to an exemption-level concern. Nevertheless, evidence of problematic governance practices may contribute to the IRS evaluation of penalties in the presence of more substantial organizational abuse.

By these speeches, examination guidelines and training materials, the IRS continued in 2009 its practice of cooperation and transparency with the EO sector. They

<sup>9</sup> *In re Citigroup Inc. Shareholder Litigation*, 964 A.2d 106 (Del. Ch. 2009).

<sup>10</sup> Remarks of Sara Hall Ingram, Commissioner, Tax Exempt and Government Entities, Internal Revenue Service, June 23, 2009. [http://www.irs.gov/pub/irs-tege/ingram\\_\\_gtown\\_\\_governance\\_062309.pdf](http://www.irs.gov/pub/irs-tege/ingram__gtown__governance_062309.pdf).

<sup>11</sup> <http://www.irs.gov/charities/article/0,,id=208454,00.html>.

<sup>12</sup> <http://www.irs.gov/charities/article/0,,id=216068,00.html>.

also combined to send a clear message that IRS intends to continue monitoring how nonprofit corporate governance relates to tax-exemption compliance.

#### 4. Executive Compensation.

There was no respite in 2009 from the close regulatory attention to nonprofit executive compensation matters, at both the state and federal level. Emphasis on reasonableness, the role of the compensation committee and use of the “rebuttable presumption” continued during the year. Media stories regularly proclaimed concern with perceived nonprofit compensation excuses.

A seminal development was the Feb. 12, 2009, release by the IRS of its long awaited final report on the results of its hospital industry compliance check audits conducted in 2006.<sup>13</sup> The final report reviewed and commented upon the executive compensation and community benefit data generated by those audits and by a limited number of follow-up examinations. In particular, the final report contained several key executive compensation-related findings arising from the questionnaires and follow-up examinations.

Principal among these findings was the widespread use by nonprofit hospitals of the “rebuttable presumption of reasonableness” to establish the reasonableness of executive compensation arrangements. Despite the fact that many of the compensation amounts reported to the IRS “may appear high to some,” nearly all amounts examined by the IRS were upheld as arrived at pursuant to the rebuttable presumption of reasonableness and within the range of reasonable compensation. The 20 nonprofit hospitals selected for follow-up examination by the IRS reported average and median compensation paid at \$1.4 million and \$1.3 million, respectively. Of the examined hospitals, 85 percent were determined to have met the rebuttable presumption, and in those instances the IRS did not assess excess benefit tax under Internal Revenue Code § 4958. However, the final report implied that such tax may be assessed in certain other cases involving the examined hospitals.<sup>14</sup>

Indeed, according to a senior IRS Exempt Organizations official,<sup>15</sup> the fundamental question is, “whether the comparables are really comparable.” This includes whether institutions are all establishing their compensation at the high-end of the range. The IRS also is expressing concern as to whether for profit compensation is truly “comparable.”<sup>16</sup> The new IRS EO examination guidelines (see discussion above) also contain a series of prompts to the examining agent relating to compensation committee practices, processes and policies.

State law scrutiny of nonprofit executive compensation was demonstrated in several high-profile 2009 developments. In September, Massachusetts Attorney

General Martha Coakley announced increased oversight of compensation practices for executives and directors of Massachusetts nonprofit charitable health care organizations.<sup>17</sup> The Attorney General’s Office issued a memorandum to the Massachusetts Hospital Association and to the state’s four largest charitable health insurance providers outlining this expanded effort. The focus of the attorney general’s review will be to address executive compensation through a periodic examination of the executive compensation practices, procedures, and outcomes within a cross section of the state’s larger and more significant public charities. While the initial focus will be on the state’s larger health care providers and insurers, the examination of executive compensation may later be extended to other sectors.

A separate, noteworthy state enforcement action was the New Jersey attorney general’s aforementioned civil complaint filed in September against Stevens Institute of Technology.<sup>18</sup> The central claims included allegations related to excessive executive compensation payable to the school president. The nature of the executive compensation-related allegations related to the reasonableness of the compensation amounts (salary and bonuses), the alleged lack of board involvement in approving such compensation, and allegedly below market interest rate loans to the president, which were allegedly forgiven.

One notable setback to state regulatory challenges to executive compensation was the Nov. 15 decision of a Baltimore (Md.) County Circuit Court judge with respect to the compensation of the former CEO of nonprofit CareFirst Inc. In 2008, the state insurance commissioner applied Maryland law to cut in half the CEO’s compensation and severance package on the grounds that it was unreasonable and that the board had “abdicated its responsibility” in approving the compensation. The Nov. 15 Circuit Court decision overturned the insurance commissioner’s order.<sup>19</sup>

#### 5. Mergers & Acquisitions.

A series of notable nonprofit merger/acquisition developments occurred in 2009. Certainly a leading event was the resolution of the long-running controversy involving the control of Colorado-based Exempla Health System between joint sponsors. The nature of the dispute was the effort of one of the sponsors (Sisters of Charity of Leavenworth Health System) to acquire membership control of Exempla’s non-Catholic hospitals from its co-sponsor, Community First Foundation.

The transaction was expected to proceed after the Colorado attorney general in late 2007 declined to review its terms and conditions, citing lack of jurisdiction. However, the transaction was subsequently confronted by substantial community (and Exempla) opposition based in part on extension of the Ethical and Religious Directives to all Exempla hospitals. The dispute was submitted to arbitration. Ultimately, the arbitrator denied all of the Exempla’s claims to invalidate the transaction, *except* for the claim that related to the ability of the community foundation to transfer its membership

<sup>13</sup> IRS Exempt Organizations (TE/GE) Hospital Compliance Project Final Report (henceforth, Final Report), Feb. 12, 2009, available at [www.irs.gov/pub/irs-tege/frepthospproj.pdf](http://www.irs.gov/pub/irs-tege/frepthospproj.pdf).

<sup>14</sup> In September, Sen. Charles Grassley introduced (and subsequently withdrew) an amendment to the Senate Finance Committee’s health care reform bill that would have eliminated the rebuttable presumption of reasonableness as a burden-shifting “safe harbor,” while requiring that its three-part process continue to be followed.

<sup>15</sup> AHLA member briefing (March, 2009), “Interview with Steve Miller (TE/GE commissioner) and Lois Lerner” (director, EO Division) (henceforth, “Miller/Lerner Interview”).

<sup>16</sup> *Id.*

<sup>17</sup> <http://tinyurl.com/mmb92p>.

<sup>18</sup> Complaint of the New Jersey attorney general, <http://www.nj.gov/oag/newsreleases09/pr20090917a-complaint.pdf>.

<sup>19</sup> Danielle Ulman, “Court Restores Former CareFirst CEO’s Compensation,” *Daily Record*, Nov. 13, 2009).

interest to its co-sponsor for consideration. The arbitrator determined that the proposed transfer was not a sale of Exempla's assets requiring the board approval under Colorado nonprofit corporate law. However, the arbitrator did conclude that the transfer of the membership interest for value to the co-sponsor violated the law, because the member has no vested property rights in a membership and no equity interest in a charitable nonprofit corporation.

Subsequent to the arbitrator's decision (on Aug. 20, 2009), the parties announced a revised agreement to transfer membership control of Exempla to the Sisters of Charity.<sup>20</sup> The terms of the revised agreement were not publicly disclosed, so it is unclear whether (and, if so, how) the arbitrator's concerns were addressed by the parties. Notably, on Nov. 5, 2009, the Colorado attorney general advised the parties that the transfer could proceed despite the provisions of new Colorado law requiring attorney general review of certain nonprofit change of control transactions.<sup>21</sup> The basis of the attorney general's decision was that the revised agreement properly was characterized as a change in bylaws and not a "transaction" requiring approval under the new law.<sup>22</sup>

Exempla was not, of course, the only significant nonprofit health care "M&A" development in 2009. For example, the announced affiliation between St. Joseph Health Services of Rhode Island, and Roger Williams Medical Center and Roger Williams Hospital became the first transaction approved under the new Rhode Island "Hospitals Conversions Act."<sup>23</sup>

On Oct. 29, the North Dakota attorney general approved the cross-border affiliation between MeritCare Health System (Fargo, N.D.) and Sanford Health (Sioux Falls, S.D.).<sup>24</sup> A planned affiliation between Dartmouth-Hitchcock Medical Center and Catholic Medical Center, both of Manchester, N.H. met with substantial public opposition, but as of this writing is proceeding toward closing through state attorney general review.<sup>25</sup>

The willingness of a state attorney general to intervene in the planned closure of a nonprofit hospital was demonstrated in Kansas. In August, the Kansas attorney general filed a civil action intended to prevent Catholic Health Initiatives Health System (Denver) from closing St. Joseph Memorial Hospital in Larned, Kan.<sup>26</sup> The attorney general alleged that the hospital's sponsor was "abandoning a valuable charitable asset," and sought to protect the hospital's "critical access"

designation.<sup>27</sup> A settlement of the dispute was reached on Dec. 23, 2009, with the parties agreeing to transfer the hospital to a party designated by the city of Larned and Pawnee County.

Also noteworthy was a Dec. 15, 2009, New Hampshire court decision in favor of a community foundation with respect to certain rights of first refusal (ROFR) under a 1983 hospital asset purchase agreement.<sup>28</sup> The case involved the community foundation's right, as successor to the former nonprofit Portsmouth Hospital, to damages and a right to repurchase the hospital from HCA as the result of a 1999 HCA internal restructuring. The ROFR arose under a 1983 asset purchase agreement. HCA argued that the 1999 restructuring was not a sale or transfer, but rather an internal tax reorganization that did not affect the hospital. The court found for the foundation on the liability phase of the litigation and the case is proceeding to the damages phase. Ultimately, the foundation could recover damages as well as the ability to re-acquire the hospital. HCA has announced that it will appeal the trial court decision.

## 6. Conflicts/Independence.

Nonprofit boards came under increased pressure in 2009 to address and resolve issues related to conflict of interest and director independence. These concerns reflected the "hot button" nature of conflicts issues, emerging best practices concerning director independence and regulatory/legislative interest in preserving the integrity of the board's decision-making process.

For example, the Massachusetts attorney general conducted an inquiry with respect to certain related party transactions and conflicts of interest involving the governing board of nonprofit Suffolk University.<sup>29</sup> The attorney general's specific concerns related to the application of the board's conflicts of interest policy to a consulting contract with a company in which a University trustee held an ownership interest. While the attorney general did not evaluate whether the transactions were, or were not, in the best interests of the university (and did not review the underlying contracts), she did express concerns over the process and documentation (or lack thereof) with respect to the university's review of the transactions. The university has agreed to make a series of refinements to its conflicts of interest procedures to address those concerns.

Also noteworthy was the settlement reached between the California attorney general, and nonprofit L.B. Research and Education Foundation, and certain of its officers and directors (including a UCLA professor who had established the research charity in 1997 and served as its chief executive officer, manager and as a director).<sup>30</sup> The attorney general had filed a complaint alleging that the founding professor and five of the charity's officers used the charity's assets to finance their own medical research and business ventures. By the settlement, the professor/director/CEO agreed to repay \$140,000 to the charity.

<sup>20</sup> Bob Mook, "Sisters of Charity of Leavenworth Health System Takes Control of Exempla," *Kansas City Business Journal*, Aug. 20, 2009. <http://denver.bizjournals.com/denver/stories/2009/06/01/daily103.html>.

<sup>21</sup> Bob Mook, "Colorado AG Won't Review Hospital Deal," *Denver Business Journal*, Nov. 16, 2009.

<sup>22</sup> [http://www.coloradoattorneygeneral.gov/sites/default/files/press\\_releases/2007/12/27.pdf](http://www.coloradoattorneygeneral.gov/sites/default/files/press_releases/2007/12/27.pdf).

<sup>23</sup> "AG Lynch Announces He Has Approved St. Joseph Health Services—Roger Williams Medical Center Affiliation"; Targeted News Service, Oct. 28, 2009.

<sup>24</sup> Gregg Blesch, "ND Attorney General OKs MeritCare—Sanford Merger," *Modern Healthcare*, Oct. 29, 2009.

<sup>25</sup> Susan Bortwell, "Hospitals' Affiliation Plan Opposed," *Valley News*, Sept. 16, 2009. <http://www.modernhealthcare.com/article/20091109/SUB/911069993>.

<sup>26</sup> Kathy Hanks, "Larned Hospital Closure Delayed," *The Hutchinson News*, Sept. 28, 2009.

<sup>27</sup> <http://www.ksag.org/page/ag-announces-larned-hospital-agreement>.

<sup>28</sup> *Foundation for Seacoast Health v. Hospital Corporation of America, et al.*, Docket No. 06-E-0583, The State of New Hampshire, Rockingham County Superior Court, Dec. 15, 2009.

<sup>29</sup> [http://www.mass.gov/Cago/docs/nonprofit/suffolk\\_university\\_070909.pdf](http://www.mass.gov/Cago/docs/nonprofit/suffolk_university_070909.pdf).

<sup>30</sup> [http://ag.ca.gov/newsalerts/print\\_release.php?id=1840](http://ag.ca.gov/newsalerts/print_release.php?id=1840).

The issue of board members simultaneously acting as vendors to the nonprofit corporation was referenced in the IRS's final report on nonprofit hospitals released on Feb. 12.<sup>31</sup> Data from the responding nonprofit hospitals confirmed the prevalence of such director-as-vendor relationships. A total of 303 (65 percent) of the 468 hospitals responding to the questionnaire reported having at least one such relationship. The most common of these were (a) the furnishing of goods, services or facilities by the director to the hospital; and (b) the hospital conducting business with a company of which the director is a partner or investor. Somewhat surprisingly, the IRS data showed that director-as-vendor relationships are more prevalent in urban and suburban nonprofit hospitals (high population and other urban and suburban) than in rural hospitals. Indeed, the IRS data is that the percentage of hospitals reporting director-as-vendor relationships generally increased as revenue size increased.

Another important aspect of this increased conflicts focus is the new Schedule L (Transactions with Interested Persons) to the Form 990. On Nov. 6, 2009, the IRS issued FAQs for Schedule L. Among the issues addressed in the FAQs are the different definitions of "interested persons" in Schedule L, and the effort required from an organization in searching for information responsive to Parts III and IV of Schedule L (relating to assistance to interested persons and business transactions with interested persons).<sup>32</sup>

The new IRS EO governance examination guidelines also include a series of conflicts-related "prompts" for the examining agent. These include specific questions concerning the effectiveness of the board's internal conflicts of interest disclosure and management process. Also included are questions regarding the presence of "horizontal" board conflicts (i.e., business and family relationships between voting board members). Indeed, a helpful example of such a horizontal conflict is provided.<sup>33</sup>

A particularly revealing development involved the public disclosures of the former chief financial officer of the prominent charity Hadassah.<sup>34</sup> This officer stated in a book published in September that she had a long-running extramarital affair with Bernard Madoff during the period while Hadassah was heavily invested with Madoff. The relationship was not known to Hadassah, even though the former CFO served on the investment committee. While no related legal action has been instituted to the authors' knowledge, the controversy served to focus attention on the extent to which personal (non-financial) relationships—typically not subject to disclosure on a nonprofit's conflicts questionnaire—can nevertheless create the potential for substantial conflicts of interest.

Greater attention also was given in 2009 to the relative independence of the nonprofit governing board, as boards and nominating committees addressed sometimes competing standards and definitions of "independent director" under the new Form 990, state nonprofit corporate law and nonprofit governance "best prac-

tices."<sup>35</sup> Additional focus on director independence issues at the public company level contributed to this increased attention.<sup>36</sup>

## 7. Tax Exempt Status.

The relationship between nonprofit and tax exempt status was questioned in 2009, with increasing scrutiny on the IRS's "community benefit" standard for hospital tax exemption. Part of this was attributed to recession-driven concerns as to whether the public benefits that nonprofit, tax exempt hospitals receive are consistent with their resources, and the tax subsidies from which they benefit. Part of this was also attributed to concerns that the community benefit standard is no longer a sufficient measurement to evaluate hospital qualifications for tax exempt status.

This long-running controversy first flared in 2009 with the February release of the IRS's final (hospitals) report. A significant portion of the final report focused on the nature and extent of activities undertaken by hospitals relating to their satisfaction of the community benefit standard.<sup>37</sup> A principal conclusion of the report was that the community benefit standard has proven difficult to administer because it (a) is based upon a "facts and circumstances" analysis as opposed to a "bright line" test; and (b) does not adequately consider the variations among different types of nonprofit hospitals, as identified in the final report.<sup>38</sup>

Significantly, the suggested need for revision to—or replacement of—the community benefit standard was a focus of the congressional debate on health care reform. As of this writing, the Senate reform proposal (House bill is silent) contains a provision that would supplement the community benefit standard by requiring nonprofit hospitals to satisfy the following additional requirements in order to maintain tax exempt status: (a) conduct an annual community needs assessment; (b) adopt, and make widely available, a written financial assistance policy combining several particular criteria; (c) commit to limit charges to patients receiving financial assistance under its plan, or receiving emergency care; and (d) forgo engaging in "extraordinary" collection practices. A new \$50,000 excise tax penalty would be imposed on any hospital failing to satisfy the community needs assessment requirement in a given year.<sup>39</sup>

## 8. Internal Controls.

A series of 2009 developments served to increase the nonprofit hospital board's need for attentiveness to the effectiveness of the organization's system of legal controls, including but not limited to corporate compliance. This need for increased attentiveness is consistent with the board's core "Caremark" compliance plan oversight obligations.<sup>40</sup>

A principal development in this regard was the 2009 enactment of amendments to the federal False Claims

<sup>35</sup> See, e.g., <http://www.irs.gov/charities/article/0,,id=211125,00.html>.

<sup>36</sup> See, e.g., 7 CARE 1431.

<sup>37</sup> <http://www.irs.gov/pub/irs-tege/frepthosproj.pdf>.

<sup>38</sup> *Id.*

<sup>39</sup> Diane Freda, "Senate Finance Bill Contains Provisions Affecting Nonprofit Hospitals, AHIA Told," *BNA's Health Care Daily Report*, Oct. 14, 2009.

<sup>40</sup> 698 A 2d 959 (Del. Ch. 1996).

<sup>31</sup> <http://www.irs.gov/pub/irs-tege/frepthosproj.pdf>.  
<sup>32</sup> <http://www.irs.gov/charities/article/0,,id=215138,00.html>.  
<sup>33</sup> <http://www.irs.gov/charities/article/0,,id=216068,00.html>.  
<sup>34</sup> <http://online.wsj.com/article/SB10001424052748704193004574588193590367178.html#printMode>.

Act, a principal source of liability exposure to hospitals. The new amendments serve to expand the situations in which a repayment obligation may arise and lead to False Claims Act liability, and may also create particular compliance challenges with respect to potential Stark violations. Accordingly, it represented a major development for hospital compliance committees.

Indeed, hospital boards also should be aware that the Department of Justice perceives the FCA amendment as making it easier for the government to pursue the provision of substandard quality of care as a false claim.<sup>41</sup> Along the same lines, hospital board members were expected to take note of the joint OIG/DOJ enforcement initiative established in May 2009 (Health Care Fraud Prevention Enforcement Action Team) and expanded in December 2009.<sup>42</sup>

Also noteworthy in this regard was the New York Medicaid Inspector General (OMIG)'s 2009-2010 work plan, which placed specific emphasis on the corporate compliance plan obligations of the governing board. The work plan noted the board's responsibility to exercise "reasonable oversight" of the provider's compliance plan. More notably, the work plan provided that, in "appropriate circumstances," where it finds that the board has "significantly failed" to satisfy its oversight duties, OMIG will consider sanctioning against board members.<sup>43</sup>

An additional example was the subtle IRS compliance initiative in 2009 involving nonprofit, tax exempt organizations and the implications of the recession.<sup>44</sup> The particular IRS concern was that in periods of severe economic turmoil, some exempt organizations could be tempted to engage in legally problematic practices in response to declining revenues and loss of charitable donations. Particular IRS focus was placed on questionable transactions, aggressive fundraising, improper application of charitable donations, increased use of noncash donation schemes, and car donation programs. Concern also was expressed with a finance-prompted reduction in corporate staff dedicated to compliance and internal due diligence functions. A related focus was on the failure to pay over withheld employment taxes to the IRS. The law allows the IRS in certain instances to assert personal liability against officers and directors deemed "responsible" for the failure to pay over. Indeed, there were at least two separate instances in 2009 where federal courts held hospital officers personally liable for payroll tax liability (in one instance, a nonprofit hospital board chair).<sup>45</sup>

## 9. Investment Management Oversight.

A particularly significant 2009 development was the increased focus on board oversight of organizational investment practices. Obviously, the recession had a dramatically negative effect on the investment portfolio value of many nonprofit organizations. In certain cases,

it exposed unusually aggressive investment policies (particularly among colleges and universities).<sup>46</sup> Some nonprofits were ensnared by Madoff and other, similar Ponzi-like scandals.<sup>47</sup> Others moved to implement governance changes intended to increase board oversight over investment practices and investment managers. Charity regulators thus were called to evaluate the impact of fraud, conflicts of interest and board/management inattentiveness on the value of nonprofit portfolios.

By and large, state charity officials responded with deference to large portfolio losses by nonprofits, electing not to pursue breach of fiduciary or similar challenges for failure to exercise investment management oversight. A primary example of such deference involved at least one prominent New York nonprofit organization, which reportedly lost millions in Madoff investments directed by fund manager Ezra Merkin, who sat on the nonprofit's investment committee. (Madoff himself was a member of the nonprofit's board of trustees). Rather than pursuing breach of fiduciary claims against the nonprofit for possible failures in its conflicts management process, the New York attorney general pursued Merkin individually, with respect to the losses incurred by this nonprofit and at another charity.<sup>48</sup> The April 6, 2009, complaint included a series of self-dealing and breach of fiduciary duty allegations alleging that Merkin failed to (a) disclose to the investment committees his ownership interests in several investments made (including some indirectly invested in Madoff-directed funds); and (b) make diligent inquiry into the risk of investing (directly or indirectly) with Madoff funds.<sup>49</sup>

Decidedly less deferential was the New Jersey attorney in the aforementioned *Stevens Institute* complaint. Many of the counts involved specific violations of the Uniform Management of Institutional Funds Act (UMIFA), and other similar laws, including allegations that the executive leadership: (a) authorized spending in excess of the previously established endowment spending rate; (b) spent substantial sums from a quasi-endowment without board approval; (c) mismanaged endowed funds; and (d) failed to adequately diversify the investment portfolio; among other allegations.

In addition, the IRS expressed concern with respect to the appropriateness of certain investments by nonprofit, tax exempt organizations. Through a series of speeches by senior IRS officials, governance practices recommendations and the Form 990, concerns have been noted with respect to (a) investments in joint ventures, for-profit entities and "complicated and sophisticated" financial products or investments that require fi-

<sup>46</sup> See, e.g., <http://online.wsj.com/article/SB125423867747249621.html>.

<sup>47</sup> See, e.g., Jonathan D. Silver, "CMU Money Managers Arrested in Fraud," *The Pittsburgh Post-Gazette*, February, 2009).

<sup>48</sup> The attorney general's complaint did not name the organization, but multiple news reports have identified it as Yeshiva University: <http://www.law.com/jsp/law/LawArticleFriendly.jsp?id=1202427634096>; <http://www.law.com/jsp/article.jsp?id=120242970924>; [http://www.charitygovernance.com/charity\\_governance/2009/01/new-york-attorney-general-fills-the-vacuum-created-by-yeshiva-universitys-apparent-failure-to-act.html](http://www.charitygovernance.com/charity_governance/2009/01/new-york-attorney-general-fills-the-vacuum-created-by-yeshiva-universitys-apparent-failure-to-act.html).

<sup>49</sup> [http://www.oag.state.ny.us/media\\_center/2009/apr/apr6b\\_09.html](http://www.oag.state.ny.us/media_center/2009/apr/apr6b_09.html).

<sup>41</sup> Marcia Semmes, "Assistant U.S. Attorney Predicts Rise in Quality of Care Cases Under FCA," *BNA's Health Care Daily Report*, Oct. 8, 2009.

<sup>42</sup> John Herzfeld, "Sebelius, Breuer Announce Expansion of Strike Force, Big New Fraud Cases," *BNA's Health Care Daily Report*, Dec. 16, 2009.

<sup>43</sup> [http://www.omig.state.ny.us/data/images/stories/work\\_plan/omig\\_work\\_plan\\_2009\\_2010.pdf](http://www.omig.state.ny.us/data/images/stories/work_plan/omig_work_plan_2009_2010.pdf).

<sup>44</sup> <http://www.irs.gov/charities/article/0,,id=200378,00.html>.

<sup>45</sup> *Id.*, See, e.g., *Verret v. U.S.*, 103 AFTR 2d 2009-1189 (2/5/09); *Doulgeris v. U.S.*, No. 8:08-cv-00282 (M.D. Fla.).

nancial and investment expertise; and (b) the quality of board and investment manager oversight.<sup>50</sup>

An additional manifestation of this increased focus was continued state action to enact the new Uniform Prudent Management of Institutional Funds Act (UPMIFA) which is being adopted by states across the country. UPMIFA was adopted in 2006 by the National Conference of Commissioners on Uniform State Laws and is intended as a replacement for the well-known UMIFA, which was adopted in 1972 and enacted in 47 states. UPMIFA's relevance to the 2008-2009 recession is that it provides a liberalized approach to a broad variety of critical topics: investment standards/fiduciary duties, endowment spending rules, delegation of investment authority, and the release and modification of gift restrictions.

## 10. Increased Internal Oversight.

A more subtle development emerging in 2009 was the extent to which nonprofit hospital/health system board members were prompted to exercise increased oversight of operations and compliance—above and beyond financial concerns. This can be traced in part to new ethical obligations of corporate counsel, increased emphasis by the OIG on board compliance obligations and conflict-free compliance reporting mechanisms, and Stark/False Claims Act risks associated with physician compensation arrangements.

For example, boards were called to be more sensitive to heightened responsibilities of their corporate counsel upon learning of wrongful conduct. States continued in 2009 to adopt changes to their own ethical rules based upon the Model Rules of Professional Conduct adopted by the American Bar Association in 2002/2003. Reflective of this was the highly publicized 2009 revisions to the Illinois Rules of Professional Conduct, based generally upon the ABA's model rules. Three of the new Illinois rules relate to compliance challenges that many health lawyers may be called upon to address, given the heavily regulated nature of the health care industry.<sup>51</sup> These new Illinois rules are intended to enhance the ability of lawyers to promote compliance with the law and, more specifically, to facilitate communication between the lawyer and the corporate client with respect to legal compliance matters. In particular, they more clearly identify the situations in which the corporate counsel has either the discretion, or is obligated, to “go up the corporate ladder” and notify executive or board leadership of corporate misconduct, including but not limited to crime or fraud. Boards thus must be attentive to these crucial compliance-based aspects of corporate counsel's professional responsibility—and provide support to counsel in its proper exercise of that responsibility.

Nonprofit health care boards also were called in 2009 to note the increased interest of the OIG with respect to the board's compliance oversight obligations, and internal compliance reporting relationships. For example, in 2009 the OIG, in conjunction with the Governance Institute, republished (with related commentary) its series

of three corporate responsibility resource guides, originally published (in conjunction with American Health Lawyers Association) in the mid-2000s.<sup>52</sup> These guides focused specifically on the board's compliance oversight role, and their republication was attributed to the continued relevance of the guides in the current health care environment. In addition, a prominent new corporate integrity agreement entered into between the OIG and a large corporation incorporated specific provisions regarding the reporting relationships of the chief compliance officer and the compliance oversight obligations of the board.<sup>53</sup>

Another contributing factor was attention given to the creation of board-level physician compensation committees, given several high profile 2009 Stark Law settlements involving employed physician compensation agreements. Particularly notable in this regard was the Aug. 25, 2009, agreement by which Covenant Medical Center of Waterloo, Iowa, agreed to pay the United States \$4.5 million to settle Stark Law based allegations arising from Covenant's relationships with five physicians. The Department of Justice had alleged that Covenant had violated Stark “by paying commercially unreasonable compensation *far above fair market value*[emphasis added]” to five employed physicians who referred their patients to Covenant for treatment.<sup>54</sup> The Covenant settlement, and similar situations, suggested that upon hospital boards take greater steps to assure the effectiveness of its ongoing oversight of internal controls intended to support the fair market value of physician compensation arrangements. The developments made dedicated board physician compensation committee a more attractive governance and compliance response.

In these and other ways, nonprofit hospital and health system boards were called upon in 2009 to consider extending greater oversight to compliance and operational issues, and exercising increased sensitivity to proper compliance reporting relationships.

## Conclusion

2009 was a year in which developments in nonprofit corporate law, as applied to hospitals and health systems, continued apace. Of particular significance were the increased level of regulatory interest in governance practices of nonprofit organizations, evolving pressures on the business judgment of nonprofit board members, and the impact on nonprofit governance of general economic conditions.

Collectively, these developments reflect greater interest in the application of nonprofit and charitable trust law concepts on a variety of public and private levels. It is the authors' perspective, however, that these developments should not be a basis to question the continued propriety and reasonableness of nonprofit status. Rather, counsel to such organizations should be mindful of identifying nonprofit corporate law as a principal legal issue when conducting any material legal analysis for a health care client.

<sup>50</sup> See, e.g., [http://www.irs.gov/pub/irs-tege/governance\\_practices.pdf](http://www.irs.gov/pub/irs-tege/governance_practices.pdf).

<sup>51</sup> [http://www.state.il.us/court/SupremeCourt/Rules/Art\\_VIII/default\\_NEW.asp](http://www.state.il.us/court/SupremeCourt/Rules/Art_VIII/default_NEW.asp).

<sup>52</sup> See, <http://www.GovernanceInstitute.com>.

<sup>53</sup> [http://oig.hhs.gov/fraud/cia/agreements/pfizer\\_inc.pdf](http://oig.hhs.gov/fraud/cia/agreements/pfizer_inc.pdf).

<sup>54</sup> <http://www.usdoj.gov/opa/pr/2009/August/09-civ-849.html>.