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New Intra-System Fiduciary Duty Decision

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Health lawyers representing nonprofit systems, or their component entities, should note a significant new ruling addressing intra-system fiduciary duties. On Thursday, May 26, a federal district court Judge issued a decision in the long-running litigation involving Lifespan Corporation and New England Medical Center (now known as Tufts Medical Center in Boston, MA). The decision is a complex, fact-intensive 83 page ruling. The court's crucial holding was that by certain of its actions or non-actions, Lifespan breached its fiduciary duties owed to NEMC, for which damages were owed. Despite its unique facts, the *Lifespan* decision may have important implications for many parent-affiliate relationships in the nonprofit sector.

Background

NEMC had been part of the Lifespan health system for five years, having entered into the affiliation as a way for it to improve its financial condition, reduce its corporate overhead, gain leverage in negotiations with health insurers and obtain referrals of complex medical cases. Lifespan's goals for the affiliation were centered on expanding its system beyond Rhode Island. Pursuant to the affiliation agreement between the parties, Lifespan (as the ultimate parent company) agreed to transfer certain sums each year to NEMC, and NEMC agreed to pay for its proportionate share of Lifespan corporate overhead costs. During the last several years of the overall five year affiliation, NEMC's financial performance declined and the parties encountered a series of business disputes related to Lifespan's performance of its parent company responsibilities. Ultimately, the parties recognized that the affiliation was not working and agreed to disaffiliate pursuant to a separate "restructuring agreement." Pursuant to that agreement, NEMC agreed to make a series of payments to Lifespan totaling \$30 million and to share with Lifespan any recovery

received from Medicare for the loss on sale/depreciation recapture resulting from the original affiliation.

Subsequent to the restructuring agreement, NEMC paid most of the \$30 million, but at the direction of its new CEO refused to make the final two installments, totaling \$3.66 million. As grounds for the non-payment, NEMC alleged that it had sustained losses far in excess of that amount due to Lifespan's misconduct in its role as parent during the course of the affiliation, and sought indemnification under the affiliation agreement. The long road of litigation began with Lifespan bringing suit in federal district court in Rhode Island against NEMC in 2006 for breach of contract, seeking to recover the unpaid restructuring amounts. NEMC filed a counterclaim for breach of fiduciary duty, unjust enrichment, and unfair business practices, and sought to recover its losses allegedly caused by Lifespan's misconduct. The district court in Rhode Island transferred the case to the federal district court in New Hampshire, when there were no judges in the federal court in Rhode Island without a conflict of interest. Shortly after the transfer, the Massachusetts Attorney General, invoking NEMC's status as a public charity, intervened in the case and also brought a counterclaim against Lifespan alleging a breach of fiduciary duties owed to NEMC (based on the same alleged misconduct as claimed by NEMC).

Key Rulings

Existence of Fiduciary Duty. Prior to trial, the court ruled in a motion for summary judgment in favor of Lifespan on the breach of contract claims, and also ruled that Lifespan had a fiduciary relationship with NEMC. The court concluded that this relationship existed by virtue of Lifespan's control over NEMC, and the "faith, confidence and trust" that NEMC placed in Lifespan's judgment and advice. Specific elements of the fiduciary relationship cited by the court were (1) Lifespan's majority control over NEMC, including the power to oversee key aspects of hospital operations, e.g. financial decisions, strategic planning, policy making, and contracts with health insurers, physicians, and academic institutions; (2) at the board level, the authority of Lifespan to appoint and remove NEMC's directors; and (3) at the executive level, the authority of Lifespan to hire, fire, and set compensation for NEMC's chief executive officer and financial officers, both of whom reported directly to their counterparts at Lifespan. Also, through the affiliation relationship, Lifespan agreed to use its best efforts to enhance NEMC's reputation.

It is interesting to note that, while applying relevant Massachusetts law to the fiduciary duty issue, the court's decision also favorably considers published scholarly analysis that argues for the existence of such a parent/affiliate fiduciary relationship in nonprofit healthcare systems.

Breach of Fiduciary Duty. The issue of whether Lifespan actually breached that fiduciary relationship was addressed in a subsequent three week bench trial (at which, in light of the summary judgment ruling in favor of Lifespan, treated NEMC and the AG as plaintiffs on their cross-complaints). The court (after rejecting certain of the claims made by NEMC and the AG) found that, with respect to certain aspects of its relationship and authority, Lifespan had violated its fiduciary duties of care and loyalty toward NEMC and had committed gross negligence, willful misconduct, and made misrepresentations to NEMC. Specifically, the court found Lifespan liable for: (1) causing NEMC to enter into a complex financial transaction in breach of Lifespan's duty of loyalty to NEMC; and (2) failing to properly negotiate or renegotiate certain contracts between NEMC and major national health insurance companies in breach of its duty of due care. The court ruled that NEMC had been damaged by these acts and awarded \$14,176,704 to NEMC. In an earlier 2010 decision in the case, the court had awarded Lifespan \$13,903,948 in its breach of contract claims against NEMC under the restructuring agreement. As such, the court on May 26 entered a *net* award to NEMC of \$272,756.

Several aspects of the court's rulings are particularly noteworthy. First, while NEMC alleged that Lifespan breached its fiduciary duties with respect to the negotiation of **all** of NEMC's contracts with healthcare insurers, the court found that the requisite gross negligence existed only with respect to the negotiation of certain of those contracts (e.g., several of those with national health insurance companies) but not with others (e.g., those with regional payors). Similarly, the court did not find in favor of NEMC's allegation of breach of fiduciary duty arising from Lifespan's role in the corporate overhead charges and in NEMC's overall financial performance.

Second, the court based its duty of loyalty ruling primarily on its determination that the Lifespan chief financial officer had a conflict of interest in the financial transaction, arising from his unusual and undisclosed personal and financial relationship with the investment banker who recommended that NEMC pursue the complex financial transaction. The court, in an extensive discussion, determined that the chief financial officer's conflict of interest was the proximate cause of the damage NEMC suffered under the financial transaction.

Analysis

The district court's decision is highly significant for existing nonprofit multi-hospital health systems, and for those that are in formation or under consideration, to the extent that it:

1. Is the second recent decision concluding that parent companies indeed owe their controlled, but separately incorporated, affiliated hospitals basic fiduciary duties (to wit,

the duties of care and loyalty) (the previous decision being the 2008 Ohio Court of Appeals ruling in *Health Alliance*);

2. Identifies parent company conduct that may in certain circumstances constitute a breach of such fiduciary duties for which monetary damages may be assessed; and
3. Reflects the willingness of the state attorney general to intervene in a cross-border dispute involving members of an inter-state healthcare system in order to protect the interests of the “home state” nonprofit hospital and its charitable assets.

What is particularly relevant here is that the nature of the fiduciary relationship determined by the court to exist is the traditional set of governance powers typically exercised by a parent corporation over separately incorporated hospital affiliates in a nonprofit healthcare system. One could argue that the earlier *Health Alliance* decision was something of an aberration given the unique provisions of the underlying joint operating agreement between the parties. That’s not the case with the *Lifespan* decision, as the parent/hospital affiliation relationship reflected normal and customary industry membership-based structuring practice. This could make it more difficult in the future for health system parent companies to refute allegations that they are in a fiduciary relationship with respect to affiliates for which a sole membership relationship exists, directly or indirectly.

The *Lifespan* decision also serves as a powerful example of the significant risks to a corporation that can arise from the failure of officers and director to adhere to established conflicts of interest policies and procedures. As such, it should serve as a prompt to nonprofit boards to revisit the vitality of existing conflicts of interest policies, related disclosure mechanisms, and procedures for the review of potential conflicts of interest-affected transactions.

The *Lifespan* decision arises in the midst of heavy nonprofit health system formation and expansion activities. It has the potential for creating significant challenges for health systems that have not adequately clarified the corporate governance obligations and commitments of their respective corporate partners. Moreover, its application to systems already experiencing tension amongst corporate partners could lead to increased structural instability and litigation. Nonprofit parent corporations should thus carefully review their governance structures to minimize such risks. This will require a clear understanding of the appropriate roles of both the “parent” and “affiliate” boards under fiduciary duty law, the specific provisions within the governance documents dealing with a “system-wide” unity of charitable purpose, and any unique affiliation provisions that may complicate their respective roles and obligations. In the context of an existing affiliation relationship, parent company governance and executive leadership should be

particularly aware of the obligations that state law may attribute to the parent company in the context of a fiduciary relationship with separately incorporated affiliates.

Accordingly, *Lifespan* may prove to be “required reading” for health lawyers representing nonprofit health system clients on corporate law matters, as well as clients considering affiliating with, or creating, health systems.

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