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Yellow Flags, Red Flags: What's a Board to Do?

BY MICHAEL W. PEREGRINE

In two recent instances, a nasty and salacious controversy between a reputable nonprofit health care organization and its CEO has served to shine a bright (and unfavorable) light on the subject of board responsiveness to suspicious conduct or events.

Both instances fueled intense media scrutiny and prompted an internal legal investigation of the underlying facts. One spawned competing litigation complaints filed by the board and the CEO, respectively, and allegedly sparked an IRS examination. The other involved a state attorney general review of the board's responsive conduct, the results of which review were made publicly available. Both instances resulted in extraordinary financial and reputational damage to the involved institutions and individuals. Most notably, in both instances warning signs were presented to individual board members (if not the full board) long before events prompted the full board to commence an investigation.

Michael W. Peregrine is a partner at the Chicago office of McDermott Will & Emery LLP. Peregrine can be reached at (312) 984-6933 or mperegrine@mwe.com.

Hindsight always offers a suspect and sterile (if not accurate) platform from which to evaluate the effectiveness of board oversight. Yet, the very public nature of these two controversies, the prominence of the institutions and individuals involved, and the suggestion that the damage could have been mitigated with attentive board action, collectively serve to transcend mere second-guessing.

As such, the controversies offer nonprofit board and executive leadership valuable lessons on oversight responsibilities in general, and the proper response to warning signs, in particular.

Factual Snapshot

The first controversy involved a well regarded health care academic institution with a volunteer board com-

prised of many leading civic and community representatives. Its CEO was a highly compensated, long serving executive with a record of accomplishment. According to news reports and court documents, the issues involved the alleged actions, executive compensation and expenditures of the CEO—and the Board's response (or lack thereof, some claimed) to various indications of impropriety and related allegations.[1] Toss in a voracious media, whistleblowers, disgruntled faculty members, executive protest resignations and wide-scale management level terminations, and the institution was presented with a major governance headache.[2]

The nonprofit alleged that the CEO incurred huge, unauthorized expenses, including but not limited to those involving personal travel and entertainment, and earned ''disproportionately high compensation''—allegations similar to those made in *The Washington Post* a few years ago concerning American University.[3] On the other hand, local media coverage focused on suggestions that the board was slow to react to multiple warning signs that popped up over a lengthy period of time, and failed to recognize the incipient signs of scandal.[4] In its public statements, the nonprofit emphasized its conduct of an independent internal forensic investigation with the assistance of prominent local legal counsel and a major accounting firm and its subsequent termination of the CEO.[5] It also stressed the board's ''intense commitment'' to high standards of organizational governance, and to the goal of its litigation—recovering corporate assets allegedly converted to wrongful use by the former CEO.[6] The ex-CEO emphatically denied all wrongdoing, and subsequently filed a claim for wrongful termination.[7]

Throughout it all, the local media kept up a steady ''Where was the board?'' drumbeat; suggesting that the board was blind to such ''obvious'' red flags as whistleblower complaints, open letters to the board, large numbers of departing faculty, information suggesting that the CEO was overpaid, and indications of highly questionable corporate expenditures.[8] When the board ultimately commenced an internal investigation, the media response was along the lines of ''What took you so long?''[9]

While there is no indication of state attorney general involvement in the controversy, it is clear that both the board and the organization suffered reputational harm from the ordeal.

The second controversy involved a well-known nonprofit medical center located in a major metropolitan area. Its CEO was highly regarded, and widely credited (internally and externally) for successfully guiding the medical center through a series of significant financial challenges which had threatened its viability. According to media reports and the attorney general's review, the core issues involved an allegedly long-term inappropriate personal relationship between the CEO and an executive employee, and the appropriateness of the Board's response to the relationship.[10]

Early in the course of employee's seven year tenure with the medical center, concerns with the relationship were raised amongst senior leadership, prompting the then-board chair and certain executive leaders to discuss the allegations with the CEO. Several years later a second board chair voiced similar concerns to the CEO, again without pursuing it through the full board. Although the employee was laid off for financial reasons in late 2009, a complaint was submitted in April, 2010 by ''concerned employees'' to several board members alleging a variety of improprieties involving the CEO, including nepotism in the employment process and improper interpersonal relationships with employees. This was followed by the submission of a second, anonymous complaint with similar allegations.[11]

At this juncture, the board instituted an internal investigation under the direction of legal counsel who was a non-fiduciary advisory board member of the medical center.[12] The board was subsequently presented with the results of the investigation, which concluded that the charge of nepotism was false as was the allegation of a second inappropriate relationship. Following significant deliberations, the board elected to retain the CEO, while expressing public disappointment in his conduct, imposing on him a $50,000 sanction, and agreeing to continue to monitor the circumstances. Furthermore, the board requested the attorney general review the board's actions, so that the public could be assured as to the appropriateness of its response.[13]

The attorney general's subsequent review did not constitute a *de novo* investigation of the allegations, but rather focused on whether (a) the CEO's actions with respect to the employee resulted in a breach of trust with respect to the administration of charitable funds; and (b) the board exercised ''due care'' in its investigation and disposition of the CEO allegations.[14] As to the first inquiry, the attorney general found no evidence of misuse or abuse of charitable funds, but observed that the CEO's actions jeopardized the reputation of the medical center and its management (describing both as

[1] Mike Hendricks, ''Pletz Firing is Suddenly Fascinating'', KansasCity.com (March 23, 2010).

[2] Alan Bavely, ''Red Flags on Pletz Had Waved For Years'', *The Kansas City Star*, June 27, 2010.

[3] ''An Open Letter to KCUMB Constituents''; http://assets.bizjournals.com/cms_media/kansascity/pdf/KCUMB%20Board%20Statement.pdf.

[4] Alan Bavely, ''Troubled Medical School Loses Two Executives,'' *The Kansas City Star*, June 22, 2010.

[5] Footnote 3, *supra*.

[6] *Id*.; ''Kansas City University of Medicine and Biosciences Files Suit Against Former President to Recover Funds,'' www.kcumb.edu (March 22, 2010); *Kansas City University of Medicare and BioSciences v. Karen Pletz*, complaint filed Jackson County, MO. Circuit Court at Kansas City, March 22, 2010, No. 1016-CV08485.

[7] *Karen Pletz v. Kansas City University of Medicine and Biosciences*, complaint filed Jackson County, MO. Circuit Court at Kansas City, March 22, 2010, No. 1016-CV08491.

[8] Alan Bavely, ''Tax Filings Call Pletz' Claims into Question,'' *The Kansas City Star*, May 18, 2010.

[9] Diane Stafford, ''Problems at university illustrate the importance of a vigilant board,'' KansasCity.com (March 28, 2010).

[10] John Cummins, ''AG Raps BIDMC Execs, Board for Levy's Lapses,'' www.healthleadersmedia.com, September 2, 2010; Letter, Jed M. Nosal, Assistant Attorney General, Chief, Business and Labor Bureau (Massachusetts Attorney General) to Stephen Kay, Chair, Beth Israel Deaconess Medical Center. (September 1, 2010) (''Nosal Letter''). http://www.mass.gov/Cago/docs/nonprofit/Beth_Israel_Hosptial_Review_090110.pdf

[11] Nosal Letter, *Supra*.

[12] *Id*., p. 4, 9.

[13] *Id*., p. 5-7.

[14] *Id*., p. 1, 3.

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valuable assets of any charitable organization).[15] The second inquiry generated starkly mixed reviews. The attorney general was complimentary of the board's action once it received the complaint, including the scope and conduct of the internal investigation and the board's related deliberations. While it noted the potential for conflict of interest arising from the engagement of an advisory board member to conduct the investigation, the attorney general found no basis to conclude that the engagement was inappropriate.[16]

That notwithstanding, the attorney general concluded that those individual board members and senior executives with prior knowledge of the allegations who failed over the intervening years to advise the full board bore ''some level of responsibility'' for the resulting events:

> *Had [the CEO] been called on his failure to act, or had his failure to act been reported to the entire board, this 'lapse of judgment' might never have occurred. For senior managers who reported to [the CEO], demanding a response was likely difficult. For board members,* ***it was their job****.'' [Emphasis added]*[17]

Significantly, the attorney general attributed this failure in large part to excessive deference by board members to the CEO in light of his record of exemplary administrative performance; *i.e.*, a lack of independent board oversight.[18] No specific liability was applied by the attorney general to these individuals, however.

The Relevant Law

The fiduciary duty implicated by both of these controversies is the ***oversight obligation***, a central component of the core duty of care. As defined in the seminal *Caremark* decision and its progeny, this obligation requires the board to ''attempt in good faith to assure that a corporate information and reporting system, which the board determines is adequate, exists.''[19] In other words, a board must have a system (*e.g.*, the corporate compliance plan) for bringing important information to its attention, and then it must continuously engage with that system.[20] Furthermore, the board has a duty to investigate on a pro-active basis ''red flags'' presented through that system—or through other circumstances.[21]

Thus, the essence of the oversight obligation is the expectation that the board will have its ''finger on the pulse'' of corporate affairs. The board is not expected to ''ferret out'' corporate wrongdoing or risk, pulling together elements of otherwise unassuming indicators, absent a particular warning sign; *i.e.*, that cause for suspicion exists. Board action is not required until it is presented with *extraordinary* facts or circumstances; *i.e.*, the proverbial ''red flag.'' At that point, the board has a known duty to act, and must do so pro-actively. While there is no legally binding definition of a ''red flag'', commentators have referred to it as ''information that alone or in combination with other known information presents the board with an immediately known duty to act.''[22] That could involve a wide range of developments—possibly including, as the above controversies suggest, evidence of CEO financial or personal improprieties. It *should not* be interpreted as limited to the traditional range of legal/regulatory/accounting violations.

In theory, the board's liability threshold for breach of the oversight obligation is very high. The *Caremark* line of Delaware cases makes it clear that ***bad faith*** is a necessary element of demonstrating oversight liability; *i.e.*, that liability arises only when ''(a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations, thus disabling themselves from being informed of risks or problems requiring their attention.''[23] In other words, director oversight liability requires evidence of a knowing or conscious disregard for corporate interests.[24]

In practice, however, the threshold of exposure is increasingly lower—at least in the nonprofit sector. Regulators (and the media) are prone to react to board conduct that falls short of traditional (*e.g.*, Delaware courts) liability thresholds when charitable assets are perceived at risk. And, to a certain extent, this is understandable—especially in the absence of a ''market remedy'' for governance deficiencies in nonprofit organizations. In the controversies described above, both the attorney general in one instance, and the media in the other, were critical of what they perceived to be failure of the board as a whole to respond to suspicious conduct—and of the failure of individual board members (including board chairs) to bring their suspicions to the attention of the full board in a timely manner. Little if any oversight credit is attributed to ''one-on-one'' communication between the Board Chair and the CEO.

What other types of board conduct could trigger similar allegations of director oversight liability? Well, perhaps evidence of directors breezing through, as opposed to really reading, the board packet. Not spending the time a particular board matter deserves. Sitting on your hands, and not asking a question even though you don't quite ''get it.'' Incuriosity. A ''whatever you guys say'' approach to the advice of management or experts. Irregular board attendance. Unresolved conflicts of interest. Failure to note ''yellow flags'' or other developments that serve to ''raise an eyebrow.'' Ignoring complaint letters addressed to the board because they are from an anonymous author or similar suspect source. ''Going easy'' on the CEO ''because he's a great guy,

[15] *Id.*, p. 8-10.
[16] *Id.*, p. 10.
[17] *Id.*, p. 10.
[18] *Id.*, p. 10-11; Note that such degree of deference to the CEO was identified by the ABA Task Force Report as a governance failure which contributed to many of the Enron-era scandals and which prompted several Sarbanes-Oxley related reforms. Notably, the concern continues in 2010 just as it did in 2002.
[19] *In re Caremark Int'l. Inc. Derivative Litig.*, 698 A.2d 959, 967-68 (Del. Ch. 1996); *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006); *In re Citigroup Inc. Shareholder Derivative Litig.*, 964 A.2d 106 (Del. Ch. 2009).
[20] *Id.*
[21] *Stone v. Ritter*, *Supra*.
[22] Mark J. Gentle and Joseph L. Christensen, ''*In re Citigroup*: The Birth Announcement and Obituary of the Duty of Business Performance Oversight,'' http://www.rlf.com/portalresource/lookup/poid/Z1tOl9NPluKPtDNIqLMRVPMQiLsSwW3Cq0!/document.name=/Bloomberg%20Law%20061509.pdf.
[23] *Id.*
[24] *Id.*

and we don't want him to leave.'' This kind of record, combined with material accounting/financial or compliance harm to the nonprofit, will prompt some serious second guessing with the media and regulators—or worse. *No wonder you couldn't see the warning signs . . . you were asleep at the switch!*

Lessons Learned

While these two controversies (and others like them) offer a ''teachable moment'' on the director's oversight obligation, we need to be careful in interpreting their true message.

They *don't* mean, for example, that the board needs to exercise pro-active diligence in the absence of any warning signs. They *don't* mean that the board needs to regularly wade into the weeds of operations. They *don't* mean that the board can't normally rely on management. They *don't* mean that board meetings need to be longer; they are *not* an invitation for inefficiencies. They *don't* mean that directors will be held personally liable for oversight failure in every instance.

They *do* mean, however, that the board should be increasingly inquisitive, increasingly attentive, more willing to pause when a ''yellow flag'' is waving, and more prepared to react when a ''red flag'' is waving. They *do* mean that organizational reputation is a charitable asset to which board oversight must be attentive.[25] They *do* mean that board members have an obligation to share with the entire board information known to them which creates cause for suspicion or concern. The same goes for executives.[26].

[25] That, in and of itself, is a concept of which the board should be made well aware because it has broad-ranging governance implications (*e.g.*, to decisions relating to conflicts of interest and to executive compensation).

[26] Report of the American Bar Association Task Force on Corporate Responsibility (''ABA Task Force Report''); http://www.abanet.org/buslaw/corporateresponsibility/, p. 31

Clearly, these controversies indicate that board members—individually and collectively—can be subject to regulatory and media criticism for failure to adequately respond to warning signs of risk to charitable assets; that oversight attentiveness is not limited to traditional matters of regulatory/legal compliance. In particular, these controversies serve as a direct reminder of the need for independent board judgment, and to avoid the trap of excessive deference to a valued executive who has otherwise earned the respect and confidence of the board. As the Massachusetts attorney general has noted, the need for board independence of management—whether it relates to conflicts of interest, executive compensation, dual office holding or diligent management oversight—is a critical component of the director's oversight and a high priority for charity regulators.

So, the lesson ultimately is for board members to ''pay a little more attention in class.'' When presented with information that looks a little funky, ask questions. Start digging. Does it make you pause? Are your eyebrows raised? Could this be a piece of a bigger puzzle? A trend? Then raise that hand straight and tall. Involve the general counsel. Share the information with the full board. Make a meaningful record of diligence; not one that is ''CYA.'' Pursue suspicious matters diligently. Don't sit on ''hot'' information, no matter how ''hairy'' it is, or how uncertain you may be of its accuracy. Don't worry about being a rumor-mongerer or about ''crying wolf''; you're a fiduciary.

The reward may not be immediate, but it will be there—especially the first time a reporter—or the attorney general, starts asking ''Where was the Board?''. . . and the board's answer is, ''Right there.''

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