



**BNA's**

# HEALTH LAW REPORTER



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## Corporate Governance

### Recent Corporate Governance Developments Relevant to Nonprofits

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The year 2009 to date has seen a noticeable “uptick” in corporate governance developments of significance to nonprofit corporations, including hospitals and health systems. While many of these developments emerge from the for-profit sector, they address corporate governance concepts fundamental to all forms of corporate entities. These include standards of conduct in change of control scenarios, fiduciary duties of nondirector corporate officers, liability for investment decisions, obligations for corporate tax payments, financial oversight duties, indemnification rights, and the direction of internal investigations. Collectively, they offer useful guidance to corporate leadership and the general counsel on the proper conduct of the nonprofit board.

Of particular interest is that many of these developments arise from issues and controversies unique to the current recessionary environment. As such, they explore matters of fiduciary duty arising from the extraordinary financial and related pressures currently facing governing boards.

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### Relevance of Delaware Decisions

Several of these new 2009 developments emerge from the Delaware courts. 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. Accordingly, rulings of Delaware courts on issues of director conduct can be particularly informative to nonprofit organizations—and those who regulate them—even where those organizations are not governed by Delaware law.

## Principal Decisions

### 1. *Lyondell Chemical*.

#### ☒ Reaffirms standards of director conduct in “change of control” settings.

This March 25 decision of the Delaware Supreme Court<sup>1</sup> serves to resolve significant uncertainty with respect to fiduciary duties in the context of a change of control (e.g., merger/acquisition) proposal.

The shareholder/plaintiffs had alleged that the Lyondell directors breached their fiduciary duty of loyalty (i.e., acted in bad faith) with respect to the process the board pursued in establishing a purchase price.<sup>2</sup> In essence, the question was whether the board violated its “Revlon” duties<sup>3</sup> by the manner in which it responded to an unsolicited takeover offer, agreed to a sales price and negotiated a sale agreement. Particular concern was focused on whether the directors’ “wait and see” approach to the circumstances surrounding the potential transaction was consistent with their fiduciary duties.

The Delaware Chancery Court, in a 2008 decision, denied the defendant directors’ motion for summary judgment, on the grounds that the board had failed to meet the burden of establishing that it had been adequately informed before making its decision (i.e., that the board’s action could be interpreted as “bad faith”).<sup>4</sup> This decision prompted concern that the influential Delaware courts were beginning to hold directors to harsher standard of conduct; i.e., a subtle erosion of the business judgment rule.

In its March decision, the supreme court reversed, finding the board’s “wait and see” response during the period before the decision to sell became certain an appropriate exercise of business judgment.<sup>5</sup> This response included an awareness of the organization’s value, solicitation and consideration of financial and legal advisors, and attempts to negotiate a more favorable transaction. In so doing, the court confirmed the principle that director “bad faith” arises only where a director “intentionally fails to act in the face of a known duty to

act, demonstrating a conscious disregard for his duties.”<sup>6</sup>

☒ **Relevance to Nonprofits:** The *Revlon* standard has not been attributed by courts to nonprofit change of control transactions. However, nonprofit director conduct in such transactions is closely scrutinized by charity regulators. Furthermore, the *Lyondell* court was not called upon to evaluate director conduct under the duty of care, which may have involved a more lenient threshold for liability. Nevertheless, *Lyondell* is a useful reaffirmation of the range of latitude which nonprofit directors conceivably may exercise in evaluating change of control transactions, within the parameters of business judgment, state law/regulation and preservation of the charitable mission.

### 2. *Gantler v. Stephens*.

#### ☒ Confirms that nondirector corporate officers owe the same fiduciary duties to the corporation as do governing board members.

This Jan. 27 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<sup>7</sup>. 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.

By its reversal, the supreme court 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. 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.

An open question from the decision is whether the business judgment rule is applicable to evaluating breach of fiduciary claims asserted against corporate officers, as it is to corporate directors. The supreme court did not address the standard of conduct applicable to officers’ duties.<sup>8</sup> Accordingly, while the *Gantler* decision confirms that corporate officers owe the same

<sup>1</sup> *Lyondell Chemical Co. v. Ryan*, C.A. No. 401, 2008 (Del. March 25, 2009).

<sup>2</sup> The *Lyondell* charter contained an exculpatory clause with respect to violations of the duty of care, so the case was based on a duty of loyalty claim.

<sup>3</sup> *Revlon* is a public company concept which requires, in essence, that when negotiating change in control transactions, the board must conduct a “market check” and accept the change of control proposal that offers the highest value. The board thus is responsible for “the maximization of the company’s value at a sale for the stockholders’ benefit.” *Revlon Inc. v. MacAndrews & Forbes Holdings Inc.*, 506 A.2d 173 (Del. 1986).

<sup>4</sup> *Ryan v. Lyondell Chemical Co.*, C.A. No. 3176-VCN, 2008 Del. Ch. LEXIS 105 (Del. Ch. July 29, 2008).

<sup>5</sup> Indeed, the *Lyondell* court ruled that the chancery court had inappropriately applied *Revlon* duties to the period of time before a decision to sell the company had been made; i.e., that *Revlon* does not apply until negotiations for sale actually begins, i.e., the board’s failure to take certain specific steps during the sale process does not per se violate *Revlon*. For a further analysis of *Lyondell*, see Finkelstein and Dreisbach, “Delaware Supreme Court in ‘Lyondell’ Decision Updates Duties of Directors in Response to a Takeover,” *BNA Corporate Counsel Weekly*, April 8, 2009.

<sup>6</sup> “Directors’ decisions must be reasonable, not perfect.” *Lyondell*, slip. op. at 17-18.

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

<sup>8</sup> See generally, Douglas H. Flaum and Shahzeb Lari, “The Applicability of the Business Judgment Rule to Corporate Officers After *Gantler v. Stephens*,” *Corporate Accountability Report*, Vol. 7, p. 454, April 10, 2009. Paul D. Manca, “Recent Delaware Corporate Governance Decisions,” American Health Lawyers Business Law and Governance Practice Group, April 2009.

duties of care and loyalty to the enterprise as do directors, it leaves unclear whether officers are entitled to the same business judgment rule protection as are directors. While there is ample suggestion under the authorities and Delaware case law that executive officers also may come within the business judgment rule, it may be left to future decisions to assure that question explicitly.<sup>9</sup> The ultimate question may be dependent upon whether an executive officer's duties are determined to be more expansive than those of a director (e.g., directors are entitled to rely on the recommendations and advice of corporate officers).

The *Gantler* decision may come as an unwelcome surprise to some nondirector officers, who may have felt that their liability exposure was limited by the terms and conditions of their executive employment agreement. The net impact of *Gantler* may prove to be an increase in instances in which fiduciary duty claims are asserted against nondirector officers. Especially given the uncertainty concerning business judgment rule protection, officers will have an increased interest in receiving both: (a) clear strategic direction and guidance from the governing board; and (b) legal advice from the general counsel and, if necessary outside counsel, before making important decisions. This is particularly the case with respect to decisions which may have material personal implications to the nondirector officers (e.g., change of control transactions, corporate restructurings and executive succession plans).<sup>10</sup>

☒ **Relevance to Nonprofits:** *Gantler* potentially increases the exposure of nondirector corporate officers to liability for breach of fiduciary duty, beyond the "four corners" of the executive employment agreement. This is consistent with the provisions of the new Model Nonprofit Corporation Act, which requires officers to observe the duties of care and loyalty and to act with the care that a person in a like position would exercise under similar circumstances.<sup>11</sup>

### 3. *In re Citigroup Inc.*

☒ **The mere fact that a corporation suffers catastrophic business losses is not, without more, a basis for director liability.**

This Feb. 24 Delaware Chancery Court decision addresses director liability exposure for investment decisions which ultimately proved disastrous for the corporation (and, as it turned out, for the national economy as well).<sup>12</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.<sup>13</sup> 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. (The Citigroup articles of incorporation contained the standard director liability exculpatory protection available under Delaware law. This limited the plaintiffs to claims based upon bad faith or intentional misconduct.) 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.<sup>14</sup>

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."<sup>15</sup> Here, court found the allegations to be more conclusory than the required particularized factual allegations demonstrating bad faith.

For example, the plaintiffs failed to specify how the board's oversight mechanisms failed to identify the "red flags" or how the board knew of those oversight failings and consciously ignored them. 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.<sup>16</sup> "Oversight duties under Delaware law are not designed to subject directors, even expert directors, to *personal liability* for failure to predict the future and properly evaluate business risk."<sup>17</sup>

In so ruling, the court drew a sharp distinction between director oversight duties with respect to monitoring corporate compliance, and those with respect to monitoring business risk. To impose *Caremark* liability on the latter (even in a case with "such staggering losses") "would involve courts in conducting hindsight evaluations of decisions at the heart of the business judgment of directors."<sup>18</sup>

☒ **Relevance to Nonprofits:** *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 the board should not take excessive comfort from this decision. State charity officials may feel compelled to scrutinize director conduct with respect to business risk decisions (e.g., investments) which lead to crippling losses for the corporation. Specific state law (e.g., UP-MIFA or UMIFA) also may have an impact. Separately, the Court's distinction between compliance risk and business risk provides the nonprofit board with strong incentives to upgrade its audit and compliance oversight mechanisms.

<sup>9</sup> Flaum and Lari, *supra*; see also, American Bar Association, Committee on Nonprofit Organizations, "Model Nonprofit Corporation Act, Third Edition, Official Text with Official Comments and Statutory Cross References (Adopted August 2008) (Hereinafter, "Model Nonprofit Corporation Act" or "MNPCA")."

<sup>10</sup> Flaum and Lari, *supra*; Manca, *supra*.

<sup>11</sup> MNPCA, Sec. 8.42, cmt.

<sup>12</sup> *In re Citigroup Inc. Shareholder Derivative Litigation*, 964 A.2d 106 (Del. Ch. 2009).

<sup>13</sup> Of course, this was the same subprime mortgage market that contributed so significantly to the current recessionary economy.

<sup>14</sup> 964 A.2d \_\_\_; see also Andrew Stern and Alex J. Kaplan, "Massive Losses Happen: Delaware Chancery Court Reaffirms The Business Judgment Rule's Protection Against Claims of Undue Risk Taking," 7 CARE 647 (May 22, 2009).

<sup>15</sup> This is the famous *Caremark/Stone v. Ritter* standard of oversight duty, well known to health care lawyers as it relates to the board's corporate compliance oversight obligations.

<sup>16</sup> 964 A.2d at 128, 130.

<sup>17</sup> *Id.*, at 131. "[W]e must not let our desire to blame someone for our losses make us lose sight of the purpose of our law." *Id.*, at \_\_\_.

<sup>18</sup> *Id.*, at \_\_\_.

#### 4. *Schoon v. Troy Corp.*

☒ **The provision of broad “advancement of expenses” rights may be an important component of director indemnification protections in an uncertain economy.**

At the core of *Schoon* was the judicial enforcement of a corporate bylaw amendment that removed a provision extending advancement obligations to former directors.<sup>19</sup>

The plaintiffs were a current and a former director of the corporation, both seeking advancement of expenses they incurred in defending a series of fiduciary duty claims asserted against them by the corporation. During the midst of the controversy that formed the basis for the fiduciary claim, the company amended its bylaws to deny former directors advancement rights. When the two plaintiffs subsequently submitted to the company their advancement claims, they were granted only a portion thereof. They then instituted this action to obtain further reimbursement.

The Delaware Chancery Court concluded that the former director was not entitled to additional advancement, because he was not a defendant in the company’s fiduciary duty litigation at the time the bylaw amendments were adopted (i.e., his right to advancement had yet to vest).

The court’s decision was highly controversial because of the value attributed to advancement rights as an indemnification-related inducement to qualified candidates to serve on corporate boards.<sup>20</sup> It also raised concerns with the equity of a company removing advancement rights for a former director that it ultimately pursued for breach of fiduciary duty claims.<sup>21</sup>

As a result of this controversy, the Delaware Legislature has within the last few months acted to revise the Delaware General Corporate Law to prohibit companies to retroactively reduce directors’ indemnification rights. Hence, although *Schoon* actually was decided in 2008, its influence manifests itself in 2009 because of these recent efforts to amend the relevant law. Such legislative efforts reflect the strong public policy support for the provision of broad advancement rights.<sup>22</sup>

☒ **Relevance to Nonprofits:** The nonprofit corporation law of most states authorizes (but does not require) the corporation to pay for or reimburse in advance the reasonable legal and related expenses of a director (or former director) made a party to a proceeding due to such board service.<sup>23</sup> These advancement provisions typically are subject to certain exceptions, and to specific authorization processes. *Schoon* serves as a useful reminder to nonprofit boards that their ability to recruit and retain competent directors may depend upon the extent to which the corporation offers a broad set of indemnification and advancement protections. This is particularly important given concerns with director liability exposure arising from the current economic recession.

<sup>19</sup> *Schoon v. Troy Corp.*, 948 A.2d 1157 (Del. Ch. 2008).

<sup>20</sup> See, “Boards Continue to Offer Directors Broad Advancement Rights After *Schoon*”; 7 CARE 631 (5/22/2009); Manca, “Recent Delaware Corporate Governance Decisions,” *supra*.

<sup>21</sup> *Id.*

<sup>22</sup> [Cite to Delaware Action]

<sup>23</sup> MNPCA Sec. 8.53.

#### 5. *Verret v. U.S.*

☒ **Nonprofit directors are well advised to take extraordinary steps to assure satisfaction of organizational obligations for payroll and related taxes.**

This Feb. 26 U.S. Court of Appeals for the Fifth Circuit decision addresses the extent to which corporate directors and officers may be considered “responsible persons” under IRC Sec. 6672 for the payment of employment taxes to the IRS. Here, the Fifth Circuit affirmed the district court’s summary judgment decision against a hospital board chair who had been assessed a \$408,918.66 penalty by the IRS for unpaid payroll taxes.<sup>24</sup>

The general rule is that individuals who are the employers’ “responsible persons” can be held personally liable for willful failure to withhold from employees’ pay or to pay over withheld taxes. The penalty imposed is the entire amount of the funds not paid to the government—potentially a very large amount.

The *Verret* court upheld a determination that a hospital board chair (serving in a voluntary capacity) was a “responsible person” under IRC Sec. 6672. During the period of the chair’s tenure the hospital was in substantial financial distress and had been frequently delinquent in the payment of payroll taxes. The board had taken a series of actions intended to prompt its executive director to make payment, but ultimately relied on the executive in this regard. The court supported “responsible person” treatment for the board chair for a number of reasons. First, the board chair had been intimately involved in corporate affairs—as a board member, officer, vendor, loan guarantor, and otherwise—for many years. (He thus could not satisfy the “volunteer director” exception). Second, the court inferred from the record that the board chair had acted willfully, in that he ignored the unpaid tax concern despite his close contact with the hospital and the executive director.<sup>25</sup>

*Verret* does not serve as evidence of a greater willingness to assess operational liability against board members. Clearly, the board chair in this case had a most unusual level of involvement that made it easy for the court to disregard his volunteer status. Nevertheless, *Verret* serves to underscore the liabilities that can be visited upon board members who actively and extensively participate in an executive capacity or who act as significant vendors to the corporation.

☒ **Relevance to Nonprofits:** *Verret* is a strong reminder of the board’s need to assure satisfaction of organizational obligations for payroll and related taxes. This is particularly important where recessionary pressures tempt the corporation to divert withheld taxes for operational purposes.<sup>26</sup> Further, the “volunteer director” exception may not be available to board members who actively participate in management. Notably, the

<sup>24</sup> *Verret v. U.S.*, 103 AFTR 2d 2009-1189 (Feb. 26, 2009).

<sup>25</sup> See, Peregrine and Mills, “New Developments Concerning Director Liability,” American Health Lawyers Business Law and Governance Practice Group Executive Summary (April, 2009).

<sup>26</sup> See, e.g., “Maintaining Public Trust in Charities During the Economic Downturn,” remarks of Lois Lerner, director, Exempt Organizations, Internal Revenue Service, before the Georgetown Law CLE Representing & Managing Tax Exempt Organizations, Washington, April 6, 2009, [http://www.irs.gov/pub/irs-tege/georgetownlawcle\\_040609.pdf](http://www.irs.gov/pub/irs-tege/georgetownlawcle_040609.pdf).

Verret court did not find that the series of directions and inquiries by the board were sufficient to satisfy the payment obligation. The strong (resulting) suggestion is that the board must “walk the check to the post of-fice.”<sup>27</sup>

### “Honorable Mentions”

In addition to the above-mentioned decisions, several other 2009 corporate governance developments are particularly noteworthy for nonprofit boards.

#### 6. Moody’s Special Comments.

**Focuses on the important relationships between corporate governance and credit rating.**

The health industry credit rating agency, Moody’s Investors Service, continued to underscore the importance of effective governance with two “Special Comments” published in April and May, respectively.<sup>28</sup> These “Special Comments” spoke to the favorable credit rating impact of two separate governance practices: (a) how decisive action by the board, working in conjunction with management, can play a favorable role in avoiding credit downgrades; and (b) greater transparency (to organizational constituents) concerning board policies, committee practices, and trustee-management tenure.

**Relevance to Nonprofits:** Credit rating agency comments reflect the financial benefits associated with effective governance practices.

#### 7. The Conference Board.

**Provides an updated set of “best practices” to pursue when the board oversees an internal investigation.**

At some point in the tenure, the nonprofit board is likely to be faced with a controversy that will require it to conduct an internal review or investigation to resolve the issue. This is particularly the case with respect to conduct arising from the current financial crisis. In a February release as part of its “Executive Action” series, the influential policy organization The Conference Board presents valuable new guidance to the board on conducting such investigations. The publication provides updated guidance on the board’s role in the entire investigation process.<sup>29</sup>

**Relevance to Nonprofits:** The nonprofit board must be attentive to its responsibilities to detect and prevent misconduct and how to effectively pursue internal reviews and investigations. The Conference Board’s publication may provide valuable guidance in that regard.

#### 8. SEC and Nonprofits.

**Recent administrative action demonstrates the willingness of the SEC to enforce disclosure obligations of nonprofits.**

The reinigorated enforcement posture of the SEC may have a spillover effect on the disclosure obligations

associated with tax exempt bonds issued by nonprofit organizations. In at least one situation of public record, the SEC has reportedly commenced an investigation of a tax exempt hospital for allegedly erroneous evaluation and management claims related to anticipated patient revenue.<sup>30</sup>

**Relevance to Nonprofits:** Given the current recessionary environment and concern with respect to financial fraud, nonprofit boards should expect the SEC to increase its vigilance with respect to the accuracy of the annual disclosure of financial information by organizations with tax exempt bonds.

#### 9. Cuomo v. Merkin.

**State Attorney General Institutes Breach of Fiduciary Duty Charges Against Charity Investment Committee Member in Madoff Scandal.**

On April 6, New York Attorney General Cuomo filed a multiple count complaint against a financier who served on the investment committee of two charities which had suffered substantial losses by investment in Madoff-related funds.<sup>31</sup> Among the counts were a series of self-dealing and breach of fiduciary duty allegations alleging that the financier failed to: (a) disclose to those committees his ownership interests in several investments made (including some indirectly invested in Madoff-run funds); and (b) make diligent inquiry into the risks of investing (directly or indirectly) with Madoff funds.

**Relevance to Nonprofits:** This action demonstrates the willingness of state charity officials to pursue breach of fiduciary and related claims against board members associated with charity losses in high risk (and ultimately fraudulent) investments. Note here that the only claims were made against the individual financier/committee member and not the full committee or the board.

#### 10. N.Y. Medicaid Inspector General.

**Board members of Medicaid providers may, in extraordinary circumstances, face personal liability for failure of the compliance plan to prevent fraud and abuse.**

The New York Medicaid Inspector General’s recently announced 2009-2010 Work Plan places specific emphasis on the corporate compliance plan obligations of the governing board.<sup>32</sup> The Work Plan notes the board’s responsibility to exercise “reasonable oversight” of the organization’s compliance plan. More notably, the work Plan provides that, in “appropriate circumstances,” where it finds that the board has “significantly failed” to satisfy its oversight duties, OMIG will consider sanctions against individual board members.

**Relevance to Nonprofits:** The OMIG Work Plan is perhaps the first formal regulatory attempt to hold nonprofit governing boards accountable for material compliance plan failures which result in preventable loss to the organization.

Nonprofit boards and their corporate counsel may find useful lessons arising from the several significant

<sup>27</sup> Id., Verret, *supra*; For a further discussion, see Peregrine and Mills, “New Development Regarding Director Liability,” American Health Lawyers Association Business Law and Governance Practice Group Executive Summary, April 2009. Portions of this discussion originally appeared in that Executive Summary.

<sup>28</sup> <http://www.moody.com>.

<sup>29</sup> <http://www.conference-board.org>.

<sup>30</sup> Steve Tweed, “Hospital Facing 2 U.S. Probes,” <http://www.post-gazette.com>, March 7, 2009.

<sup>31</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>32</sup> <http://www.omig.state.ny.us/data>.

corporate governance decisions emerging from Delaware and other courts in 2009 to date. Even if the decisions are not directly applicable on all points, they nev-

ertheless offer useful guidance on how courts approach certain fiduciary duty issues, and on the types of board conduct that may prove controversial.