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Corporate Governance

Key Nonprofit Corporate Law Developments in 2006

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The year 2006 witnessed a series of dramatic and significant developments in nonprofit corporate and charitable trust law, as they affect the control and operation of hospitals and health care systems. This is consistent with a near decade-long trend that has made corporate law a key feasibility consideration for these organizations.

These developments have most significantly affected the following areas: (a) oversight regulation of nonprofit organizations, at both the federal and state levels; (b) corporate responsibility and Sarbanes-Oxley-based compliance; (c) fiduciary standards of conduct; (d) financial performance and disclosure; and (e) business transactions, both external and intrasystem.

Furthermore, these developments reflect the continuation of nonprofit corporation law trends that the authors believe counsel should consider as they advise their nonprofit health care clients on transactional, structural and governance matters. These trends include:

- The continued “close scrutiny” by state attorneys general of the business practices of nonprofit health care providers;
- The ongoing focus of state and federal regulators on executive compensation arrangements of nonprofits;
- An increasing recognition from a public policy perspective that governance structures of nonprofit organizations must be improved;
- The continuing evolution of governance “best practices” and their relationship to fiduciary obligations;
- The ongoing pattern of stakeholders using charitable trust laws to seek remedies that would not be available under nonprofit corporation law; and
- The willingness of legislators, courts, and regulators to hold nonprofit directors accountable for the conduct and performance of the corporations they serve.

Based on these trends, our list of major nonprofit developments for health care providers in 2006 follows.

1. **Fiduciary Duty.** Several new judicial decisions and other developments in 2006 contributed to the body of fiduciary duty law, particularly as it may apply to directors of nonprofit corporations. Most prominent among these was the June decision of the Delaware Supreme Court, affirming that the directors of the Walt Disney Company did not violate their fiduciary duty in connection with the hiring and subsequent termination of Michael Ovitz as Disney's Chief Executive Officer.¹ In

¹ *In re Walt Disney Derivative Litigation*, No. 411, 2005 (June 8, 2006). Delaware court decisions are worthy of note by

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so doing, the court affirmed the much-scrutinized 2005 Chancery Court decision of Chancellor William B. Chandler III, holding that aspirational best practices, while a worthwhile goal, do not constitute the legal standard under which director liability is to be judged.

The Supreme Court's 2006 decision confirms the vitality of the business judgment rule, even under fact patterns that are less than ideal. Despite the "imperfections" in the Disney board's decision making process, its exercise of good faith and due care was sufficient to sustain the presumption of business judgment rule protection. Yet, corporate directors considering similar circumstances, and decisions, on a going-forward basis would be well-advised to consider the criticisms leveled at the Disney board and attempt to avoid the more obvious pitfalls, at a minimum.²

A decision of the New York Supreme Court in early spring served to renew attention to the so-called duty of obedience to charitable mission, particularly as it relates to important decisions such as change-in-control transactions. In *64th Associates v. Manhattan Eye, Ear & Throat Hospital*,³ the court dismissed a lawsuit brought by a real developer against a well-known specialty hospital (MEETH) ending a five year legal conflict surrounding the attempted sale, in 1999, of MEETH to the developer. The original sale had been blocked in 1999 by the Supreme Court, in a challenge initiated by then Attorney General Spitzer, on the grounds that it would violate New York nonprofit corporate law and constituted a violation of the directors' duty of obedience to purpose. The instant litigation was based on the developer's attempt to recover a "break-up fee" associated with the original sale. The Supreme Court refused to enforce payment of the fee, on the basis that it was "not fair and reasonable" to MEETH and that, essentially, payment of the fee would have been the fruit of a proposed transaction that had previously been determined to have violated the duty of obedience to purpose. While the MEETH "saga" is based in large part upon application of particular New York law, its emphasis on the duty of obedience to purpose in "change-in-control" transactions is noteworthy.

Similar fiduciary guidance came later in the year from a highly unlikely source—the Hewlett-Packard board of directors. According to media reports, a principal catalyst for the ill-fated internal investigation of Hewlett-Packard board members, and the related controversy surrounding "pretexting" practices, was a concern that one or more directors had shared confidential corporate information (e.g., summaries of highly confidential board meetings, and a corporate strategy) with the financial media, to the potential detriment of the corporation.⁴ The "pretexting" controversy offered

nonprofit corporations for multiple reasons, including the fact that Delaware has a unified corporation code applicable to for-profit and nonprofit corporations alike.

² For a more detailed discussion of the facts and of the Supreme Court's decision, see Peregrine, Schwartz and Horton, "Delaware Supreme Court affirms *Disney*, Continuing Vitality of Business Judgment Rule," AHLA Corporate Governance Task Force (August 2006).

³ Supreme Court of New York, New York County, 2006 NY Slip Op. 50410U; 11 Misc. 3d 1067A, 867 N.Y.S. 2d 701.

⁴ Alan Murray, "Directors Cut: H-P Board Clash Over Leaks Triggers Angry Resignation," *The Wall Street Journal*, September 6, 2006; Julie Creswell, "A Board Brawls, in Public No Less," *The New York Times*, Sept. 7, 2006.

nonprofit corporations a good opportunity to revisit obligations of directors to maintain confidentiality of sensitive financial and strategic information consistent with the fiduciary duty of loyalty.

2. Best Practices Developments. The preparation and public dissemination of corporate governance "best practices" compilations—by a variety of public and private sources—continued to attract attention in the nonprofit sector in 2006. This is particularly the case given the Delaware Supreme Court's *Disney* decision, which made it clear that implementation by boards of evolving perceptions of best practices is an admirable aspiration and can constitute evidence of good faith.

It is in that context that, for example, developments such as the new governance principles adopted by the American Red Cross became noteworthy.⁵ Announced in late October, the principles were adopted as a result of an intense, six-month self-examination and comprehensive review of the Red Cross' governance practices, as conducted by its Governance Committee. The examination and review had been prompted by Senate Finance Committee scrutiny. To "mainstream" nonprofits, the most relevant changes recommended for adoption were those that would: (1) reduce the board size by more than half over a six year period; (2) create greater clarity between the board's obligation to provide oversight and the role of professional leadership to provide day-to-day management over operations; (3) establish a single category of "Governors," eliminating the current distinction with respect to the selection of members; (4) reduce the role of the Executive Committee, consistent with the downsizing of the full board; and (5) adopt a series of other important corporate compliance-related measures.

During 2006, the prominent National Association of Corporate Directors (NACD) published two editions in its helpful series of "Blue Ribbon Committee" reports. The first report, "Director Liability: Myths, Realities and Prevention," focuses on actions that directors may take to reduce, or at least more effectively manage, their liability exposure.⁶ Among the recommended practices include the establishment of "levels of authority" for the corporation, identifying those matters for which board authorization is required, and those matters for which discussion and review with management is sufficient. Other recommendations addressed the flow of information to the governing board, as a critical aspect of the decision-making process. A subsequent Blue Ribbon Report addressed CEO succession planning.⁷

In addition, the Panel on the Nonprofit Sector issued a Supplemental Report to Congress, following up on its seminal 2005 Final Report.⁸ Also entitled "Strengthening Transparency, Governance and Accountability of Charitable Organizations," the Supplemental Report proposed a broad set of additional governance and transparency-related recommendations. Particularly

⁵ http://www.redcross.org/services/governance/0,1082,0_234_00.html.

⁶ Report of the NACD Blue Ribbon Commission, "Director Liability: Myths, Realities and Prevention," The National Association of Corporate Directors (<http://www.nacdonline.org>).

⁷ Report of the NACD Blue Ribbon Commission, "CEO Succession Planning," The National Association of Corporate Directors (<http://www.nacdonline.org>).

⁸ <http://www.nonprofitpanel.org/supplement/>.

significant to “mainstream” nonprofits were those relating to charitable solicitation, compensation of trustees of charitable trusts, the prudent investor standard, nonprofit conversion transactions, disclosure of unrelated business activities, federal court equity powers and standing to sue. Significantly, the Panel recommended that redress for fiduciary duties remain the province of state, and not federal courts. The Panel has indicated that it will continue its work in 2007 to develop recommendations on financial reporting standards, improvements to the Forms 990 and 990-PF, and self-regulation by charitable organizations. It is also expected to identify sample governance policies.

3. **Senate Finance Committee Activity.** As in the past, the Senate Finance Committee, under the leadership of Senator Charles F. Grassley (R-Iowa), aggressively addressed nonprofit corporate law issues affecting a wide variety of industry sectors in 2006. For example, the Committee began the year with a review of the governance practices of the American Red Cross.⁹ Concern was expressed with both the manner in which the organization was using donations made to assist with Katrina recovery efforts, as well as with respect to the structure and operation of ARC governance. The Committee also continued its close scrutiny of the governance practices of American University, which it had begun in the fall of 2005.¹⁰ Particular Committee scrutiny was applied to the development by the University of new governance policies and procedures.

By midsummer the Committee began to focus on a series of perceived problems in the nonprofit tax-exempt sector, including those relating to nonprofit hospitals, nonprofits that may be used for political purposes, board member compensation and trustee fees that “appear to function like for-profit businesses and undercut their business competitors.”¹¹ On September 12, the Committee released its written summary of responses by those nonprofit hospitals which had received a controversial 45-question community benefit-based inquiry letter initially sent by Senator Grassley on May 25, 2005.¹² These responses prompted Senator Grassley to comment on his perception of the lack of differences between for-profit and nonprofit hospitals in terms of serving the community, and with respect to executive compensation practices.¹³

On September 26, the Committee held a hearing to address the continued relevance of the community benefit standard of tax-exempt status for hospitals.¹⁴ The hearing’s structure and proceedings reflected Committee interest in common definitions and reforms in areas such as community benefit, charitable care, charges to

the uninsured, debt collection and joint ventures.¹⁵ In connection with the hearing, Senator Grassley directed Committee staff to prepare a discussion paper with respect to a common reporting system among all nonprofit hospitals for charity care and community benefit. The fate of these legislative initiatives, and the Committee’s overall focus on nonprofit issues, is, of course, subject to change, dependent upon the priorities of the new Committee Chairman.

4. **Executive Compensation.** In 2006, an extraordinary amount of emphasis was placed on the executive compensation practices of nonprofit corporations. A prominent development in this regard was a “partial summary judgment” decision in the long running, controversial litigation in which New York Attorney General Spitzer challenged the executive compensation arrangements involving New York Stock Exchange CEO Richard Grasso.¹⁶ In that ruling, the Judge concluded, among other things, that Grasso breached a fiduciary obligation to regularly advise the compensation committee concerning the amount of his benefits, particularly with respect to the “multiplier effect” of pay increases on SERP benefits. For this and other reasons, Mr. Grasso was ordered to repay the NYSE a sizable portion of the contested compensation arrangements. A subsequent ruling by the Appellate Division of the Supreme Court stayed this order until the appeal can be heard.¹⁷

On July 31, the Government Accountability Office issued a report, “Nonprofit Health Systems: Survey on Executive Compensation Policies and Practices.”¹⁸ This Report served to compile the results of a survey distributed in early 2007 to a large number of nonprofit, tax-exempt hospitals and health systems. Report topics included (a) the governance structure with respect to executive compensation; (b) the basis for compensation and benefits earned by, or awarded to, or paid to hospital system executives; and (c) internal controls with respect to executive travel, entertainment and gifts. Interestingly, Senator Grassley was highly critical of the compensation practices cited in the Report and vowed to pursue legislative reforms to place greater control on such practices in the nonprofit sector.¹⁹

These developments were complimentary to the series of 2006 initiatives of the Internal Revenue Service, including the Community Benefit Compliance Check Questionnaire.²⁰ This “voluntary” questionnaire was distributed to approximately 650 nonprofit, tax-exempt hospitals and health systems. A discrete section of the questionnaire was devoted to a discussion of the execu-

¹⁵ *Id.*

¹⁶ *Spitzer v. Grasso*, Supreme Court of New York, New York County, 2006 NY Slip Op. 520 19U, 13 Misc. 3d 1227A, 236 N.Y.L.J. (Oct. 18, 2006); see also Peregrine, DeJong and Schwartz, “Grasso’s message to Compensation Committee (and to CEOs)”;¹⁷ AHLA Corporate Governance Task Force Executive Summary (November 2006).

¹⁷ “Grasso Wins Stay of Court Ruling,” *The Wall Street Journal*, Dec. 1, 2006.

¹⁸ <http://www.gao.gov/new.items/d06907r.pdf>.

¹⁹ Press Release by Senator Charles F. Grassley, of Iowa, Chairman U.S. Senate Committee on Finance, July 28, 2006 (<http://finance.senate.gov>).

²⁰ IRS Form 13790, “Compliance Check Questionnaire Tax Exempt Hospitals”; see also Peregrine and Louthian, “Update: IRS ‘Community Benefit’ Compliance Check,” *Health Lawyers News*, July, 2006 (p. 4).

⁹ “Grassley Questions Effectiveness of Red Cross Board,” *Tax Notes Today*, (Tax Analysts), Dec. 29, 2005.

¹⁰ Press release by Senator Charles F. Grassley, Chairman, U.S. Senate Committee on Finance, May 19, 2006 (<http://finance.senate.gov>).

¹¹ Press release by Senator Charles F. Grassley, Chairman, U.S. Senate Committee on Finance, June 1, 2006 (<http://finance.senate.gov>).

¹² Press release by Senator Charles F. Grassley, Chairman, U.S. Senate Committee on Finance, Sept. 12, 2006 (<http://finance.senate.gov>).

¹³ Press release by Senator Charles F. Grassley, Chairman, U.S. Senate Committee on Finance, July 28, 2006 (<http://finance.senate.gov>).

¹⁴ <http://www.senate.gov/~refinance/sitepages/hearing091306.htm>.

tive compensation practices at the hospital/health system.

Other relevant executive compensation developments included the new SEC Rules addressing enhanced disclosure for executive compensation arrangements.²¹ The new rules require publicly traded companies to provide an enhanced level of information concerning executive pay, with focus on such matters as the lump sum cost of retirement benefits, the cost of severance pay, change of control payments and other elements of an executive's compensation (i.e., the so-called "stealth wealth" components). As such, the new disclosure rules, with their emphasis on transparency, are expected to have a "spillover" effect on nonprofit practice and regulation.

5. Corporate Controversies. Several prominent nonprofit organizations found themselves embroiled in corporate/governance controversy in 2006, whether through Attorney General actions or otherwise. In an action reminiscent of the controversy involving Allegheny Health Education and Research Foundation, the chief financial officer of Milwaukee Public Museum was indicted by the Milwaukee District Attorney for allegedly improper use of restricted gifts.²² The Minnesota Attorney General conducted a vigorous business compliance review of Blue Cross Blue Shield of Minnesota, focusing on executive compensation, travel and entertainment, consulting expenses, reserves and surplus and affiliate transactions and administrative expenses.²³ The United Way of New York City conducted an internal investigation which determined that a former executive diverted over \$225,000 of charitable funds for personal use, during 2002 and 2003.²⁴ Michigan Attorney General Cox initiated a review of New York City-based Ford Foundation for failing to make what the Attorney General viewed as a sufficient amount of charitable grants to Michigan-based charitable organizations.²⁵ Vanderbilt University was the subject of a feature in *The Wall Street Journal* which raised a series of issues concerning University governance, including those relating to conflict of interest and executive compensation.²⁶ The American Civil Liberties Union received substantial criticism for its since-withdrawn plan to discourage board members from publicly criticizing organization practices.²⁷

The September 29 decision of the Illinois Department of Revenue denying the property tax exemption of Provena Covenant Medical Center,²⁸ and the broader federal and state charity care/property tax exemption

challenges, have corporate as well as tax implications. Specifically, the nature of these challenges addresses core principles of nonprofit as well as tax exempt status. Board and executive leadership must recognize the implications that these actions, where successful, may have on the organization's status as a nonprofit corporation under state law. Furthermore, as "mission oversight" is a fundamental component of the fiduciary duty of loyalty, board members have reason to be particularly attuned to these challenges.

A series of legislative, regulatory and third party actions in late 2006 represented the vanguard of what can be expected to be a broad public debate on the appropriate balance of corporate accountability regulation. Among these developments were the Report of the Committee on Capital Markets Regulation, the new "McNulty Memorandum" from the Department of Justice, and new proposed SEC rulemaking on the application of Sarbanes Section 404, particularly on smaller public companies.²⁹ 2007 is expected to see additional studies and reports on the impact of the current impact of corporate oversight/regulation.

However, it is important to recognize this movement is a limited agenda aimed at certain aspects of oversight of publicly traded organizations. It is not a broad effort to unwind the core themes, statutes and regulations of the corporate accountability environment, particularly as they relate to the nonprofit sector.³⁰

Furthermore, the current controversy involving the legality of "options backdating" is threatening to serve as a reminder to legislatures and the public that some form of regulatory oversight of corporate governance remains necessary.

6. Derivative Action. Derivative action—normally associated with publicly held companies—made a significant appearance in the nonprofit sector in 2006. Specifically, the Tennessee Court of Appeals upheld a trial court's decision to remove the board of directors of a nonprofit Memphis healthcare facility, in an action arising from a derivative action initiated by the former CEO and two board members.³¹

The derivative action was based in large part on the board's alleged failure to take action against the board chair, who was found liable for a series of False Claims Act violations. The significance of this case lies in part in the fact that the nonprofit corporate laws of many states incorporate some kind of derivative action authority. Such derivative actions may typically be instituted only by individuals who were members or directors at the time of the proceeding, even if not necessarily at the time of the complained of act.

The Memphis Health Center case is also significant because the appeals court found that, at least under Tennessee law, an *ex-officio* director, here the CEO, could be a complainant in a derivative action. Also, the principal allegation on which the derivative action was based was a breach of the board's fiduciary duty in not taking any action to remove or even to investigate the

²¹ <http://www.sec.gov/rules/final/2006/33-8732afr.pdf>.

²² "Former Museum Official Charged; Prosecutors Cite Cash Shuffle, Coverage": *Milwaukee Journal Sentinel* Oct. 12, 2006.

²³ <http://www.ag.state.mn.us>.

²⁴ Stephanie Strom, "United Way Says Ex-Leader Took Assets," *The New York Times*, April 14, 2006.

²⁵ Harvey Dale and Jill Horwitz, "Michigan's Dangerous Attempt to Distort Donors' Intentions," *The Chronicle of Philanthropy*, August 17, 2006.

²⁶ Joann S. Lublin and Daniel Golden, "Golden Touch: Vanderbilt Runs In Lavish Spending By Star Chancellor," *The Wall Street Journal*, September 26, 2006.

²⁷ Stephanie Strom, "A.C.L.U. Warned on Rules to Limit Members' Speech," *The New York Times*, June 19, 2006.

²⁸ *The (Illinois) Department of Revenue v. Provena Covenant Medical Center*, appeal filed, Ill. Cir. Ct., No. 2006MR00597, 10/26/06.

²⁹ See, e.g., "Interim Report on the Committee on Capital Markets Regulation" (Hubbard, Thornton, Scott, Co-Chairs), Nov. 30, 2006. <http://www.capmktreg.org/index.html>.

³⁰ See also Peregrine, "Corporate Accountability Reform Proposals: Is the Pendulum Swinging Back?" *Health Lawyers Weekly* (American Health Lawyers Association), Dec. 8, 2006.

³¹ *Memphis Health Center Inc. v. Grant*, Tenn. Ct. App. No. W2004-02898-COA-R3-CV, July 28, 2006.

board chair's conduct. Hence, in contentious board scenarios, the derivative action may prove to be a vehicle by which disaffected directors of a nonprofit health care entity may take action that they feel bound to undertake on behalf of the mission of the organization and their own fiduciary duties.

7. **Corporate Liability.** The "liability shields" supporting the traditional parent/subsidiary health care system corporate structure may be affected by a recent decision of the Illinois Appellate Court.³² This decision suggests that a parent corporation may be held liable for the actions of its subsidiary under the "direct participant" theory even where it has implemented the traditional measures to assure corporate separateness.

The issue arose in the context of the appeal of a grant of summary judgment in favor of a defendant, the parent/sole shareholder of an oil refining company, in a wrongful death action involving the accidental death of several refining company employees. The parent had successfully argued that it owed no duty to the deceased employees as it was a separate and distinct legal entity from the refining company, and the plaintiffs, the decedents' estates, had not sought to pierce the corporate veil. On appeal, the plaintiffs argued for liability on the basis that the sole shareholder/parent had been a "direct participant" in the alleged wrongful deaths because the parent, by its actions, had "directly intervened" in the subsidiary's actions in a manner that contributed to the deaths. To support their arguments, the plaintiffs relied on evidence that (a) the parent's directors prepared and approved the subsidiary's budgets; (b) the Board of the parent and of the subsidiary often met simultaneously; (c) the parent mandated business strategy for the subsidiary; and (d) the parent sought to increase its own cash reserves by materially decreasing capital expenditures of the subsidiary.

In reversing the grant of summary judgment, the Appellate Court referred to a series of "well established" cases holding the parent responsible for the actions of its subsidiaries where the parent directly intervenes in the management of its subsidiaries so to treat them as merely departments of its own enterprise. These cases found liability not on the basis of "alter ego" or "corporate veil piercing" doctrines, but instead where the parent was a "direct participant" in the suspect practices. In the Illinois case, the plaintiff's allegation was that the parent company's own actions, mandating that the subsidiary operate in a survival mode, and materially reducing capital expenditures, and not its legal relationship to the subsidiary—created the condition within the refinery that led to the deaths. By alleging that the parent "interposed a guiding hand" in subsidiary management, the court held that the plaintiff had involved the "direct participation" exception.

What is disconcerting about this new Illinois decision is the extent to which liability is assessed against the parent not because of its legal relationship to the subsidiary, as in corporate veil piercing, but rather because the parent is directly a participant in the wrong complained of. The factors cited by the Appellate Court as evidence of such "intermeddling" are uncomfortably similar to practices used by a number of nonprofit health system parent corporations to achieve governance and operational efficiencies, particularly in the

context of the shift to "systemness": preparing and approving the subsidiary's budget, simultaneous meetings of parent and subsidiary boards, and mandating strategic initiatives.

To the extent, then, that the "direct participant" theory of liability is accepted by other jurisdictions, parent corporations will be called upon to give much greater consideration to the legal implications of their strategic directions to subsidiaries. Where those directions or mandates are perceived as a proximate cause of some harm caused by the subsidiary, or legal violation by the subsidiary, a third party may seek relief for the parent's "intermeddling," regardless of its legal status with the subsidiary.

8. **Statutes, Regulations and Uniform Laws.** 2006 was notable for the adoption of several new statutes, regulations and uniform laws affecting the nonprofit sector. Most notable among these was the August 17 adoption of the Federal Pension Protection Act of 2006, which contained a number of provisions dealing with charitable organizations.³³ This new Act made numerous significant changes to the Internal Revenue Code affecting charitable giving and the operation of tax-exempt charitable organizations. In particular, the charity-based provisions of the Act provide for (a) new rules affecting charitable giving; (b) new reporting rules for unrelated business income and new rules with respect to intermediate sanctions excise taxes for "organizational managers"; (c) stricter rules for private foundations; (d) stricter rules for "supporting organizations"; and (e) new rules for donor-advised funds.³⁴ Especially with respect to private foundations and public charities, including supporting organizations, the Act has been characterized as the broadest set of regulations to affect charities since the Tax Reform Act of 1969. The Act did not, however, include many of the nonprofit organization/governing board provisions that had been championed by the Senate Finance Committee.

On the state level, notable was the effort of the Ohio Attorney General to adopt new administrative rules designated to make Ohio charities "more accountable" to the public.³⁵ The new rules underwent substantial modification before finalization, to reflect input received from the nonprofit sector. A key aspect of the rules is the establishment of an eleven member Charitable Advisory Council, consisting of representatives of the nonprofit sector, which is to recommend to the Attorney General model policies and a training program on the legal responsibilities of charities. Other new provisions call for charitable hospitals to register and file annual reports with the Attorney General.

A proposed major revision to the District of Columbia's Nonprofit Corporation Act attracted attention due to the potential ambiguity in certain of its provisions, and the proposed expansion of the authority of the District's Attorney General to investigate nonprofit organizations.³⁶ The potential ambiguity arose from the pro-

³³ P.L. 109-280 (Aug. 17, 2006).

³⁴ Client Memo, "Charity-Related Provisions of the Pension Protection Act of 2006: Significant New Rules and Restrictions," Elizabeth Mills and Neil Kawashima, McDermott Will & Emery LLP, <http://www.mwe.com/info/news/wp0906a.pdf>.

³⁵ <http://www.ag.state.oh.us/press/06/07/pr060728.asp>.

³⁶ "DC Associations Successful in Tabling Revision of District's Nonprofit Corporation Act," ASAE and the Center for Association Leadership, Nov. 30, 2006, <http://>

³² *Forsythe v. Clarke USA, Inc.*, 361 Ill. App. 3d 642, 836 N.E.2d 850 (2005).

posed definition of a nonprofit purpose, as “a purpose other than to generate income, profit or an increase in monetary value.” The related concern was that such a definition could be applied in a manner as to deny nonprofit status to organizations that generate income, or an excess of revenue over expenses. The proposed revisions would also have established an extremely low threshold for the court, on the petition of the Attorney General, to place a nonprofit corporation in receivership. These and other controversial provisions led to the proposal being withdrawn by its sponsor in late November.³⁷

It is also useful to note the continued evolution in 2006 of new uniform laws and model acts. Most notable were the progress made towards a new revision of the Model Nonprofit Corporation Act and the July 13 adoption by the National Conference of Commissioners on Uniform State Laws of the new Uniform Prudent Management of Institutional Funds Act (UPMIFA), which provides statutory guidelines for management, investment and expenditures of endowed funds held by charitable institutions.³⁸ The new UPMIFA, which incorporates the provisions of modern portfolio theory, is intended to permit more efficient management of funds for charitable purposes.

9. Compliance Plan Oversight. The role of corporate directors in providing oversight of the organization’s compliance plan came into sharper focus with a series of events in 2006. For example, a November decision of the Delaware Supreme Court affirmed the seminal *Caremark* standard as the basis for the evaluating director’s compliance plan oversight duty, in a manner which appears favorable to directors.³⁹ Specifically, the Court provided that only a “sustained and systemic” failure to exercise oversight (e.g., an “utter failure” to assure reasonable reporting system) would justify the imposition of liability on a director. As with its earlier decision in *Disney* the Delaware courts appear to be backing away from language that implies a greater liability risk, in favor of a more lenient “conscious disregard” standard.

In addition, the Department of Justice’s revised guidelines for the prosecution of corporations preserve in its entirety the provisions from the original set of guidelines that set forth the perceived characteristics of an effective compliance program. Although non-industry specific, the revised guidelines provide useful direction on the focus of the Department’s inquiry when evaluating the substance and effectiveness of the compliance plan.⁴⁰

10. Financial Distress. The past year also witnessed several new developments relating to the governing board’s fiduciary obligations in times of organizational financial distress. First among these was the *Gottlieb v. Hicks* litigation, in which the Chapter 7 Bankruptcy Trustee for Granada Hills Community Hospital had sued the hospital’s former board members for breach of fiduciary duty in connection with the hospital’s failed

Chapter 11 bankruptcy reorganization. On January 23, the U.S. District Court (Schiavelli, J.) ruled in favor of the defendant’s motion for summary judgment against the bankruptcy trustee.⁴¹ The defendant directors had argued that their conduct throughout the reorganization process was subject to business judgment rule protection, as having been made in good faith with the reasonable belief that they were actions in the best interests of the organization. The directors had argued that they had relied in good faith upon information provided by the hospital’s officers, consultants and advisers and, if that information was incorrect or incomplete it was not a basis for imposing liability on the directors.

Further guidance on this topic came from the decision in the *Trenwick America* litigation, in which the Delaware Chancery court concluded that Delaware law does not recognize a cause of action against corporate directors for contributing to the “deepening insolvency” of a corporation.⁴² In so doing, the Chancery Court defended the right of directors to the protection of the business judgment rule—particularly during the so-called “Zone of Insolvency.” According to some commentators, this decision may serve to limit the future application of “Zone of Insolvency” liability claims.

Other Highlights. Other 2006 nonprofit corporate developments worthy of note include the following:

- The New York City Bar Association’s Nov. 30 report, “Task Force on The Lawyer’s Role in Corporate Governance,”⁴³
- The litigation between The Health Alliance of Greater Cincinnati and The Christ Hospital in Cincinnati with respect to their corporate affiliation;⁴⁴
- The controversy surround the Georgetown University Form 990, in which former basketball coach John Thompson was listed as one of the organization’s highest compensated employees,⁴⁵ and
- The implications on federal nonprofit oversight from the Democrats assuming control of Congress.

Conclusion. 2006 was a year in which developments in nonprofit corporate law, as applied to hospitals and health systems, continued apace. Of particular significance was the increased level of regulatory interest in governance practices of nonprofit organizations, and a willingness to closely review and question such practices.

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.

⁴¹ *Gottlieb, Trustee v. Hicks*, C.D. Cal., No. CV04-7318GPS (SSx), bench ruling Jan. 25, 2006.

⁴² *Trenwick America Litigation Trust v. Ernst & Young LLP*, C.A. No. 1571-N, WL 2333201 (Del. Chanc. Ct. Aug. 10, 2006).

⁴³ http://www.nycbar.org/pdf/report/CORPORATE_GOVERNANCE06.pdf.

⁴⁴ *The Health Alliance of Greater Cincinnati v. The Christ Hospital*, Ohio Ct. Com. Pls., No. A0601969.

⁴⁵ Himmelsbach, “Hoyas’ First Thompson Era Has Long Life On the Payroll,” *The New York Times*, Feb. 19, 2006.

www.asaecenter.org/AboutUs/newsreldetail.cfm?itemnumber=24032.

³⁷ *Id.*

³⁸ <http://www.nccusl.org/update/DesktopModules/NewsDisplay.aspx?ItemID=170>.

³⁹ *Stone v. Ritter*, 2006 Del. LEXIS 597 (Nov. 6, 2006).

⁴⁰ <http://www.usdoj.gov/dag/speech/2006/mcnulty-memo.pdf>.