

New Jersey Law Journal

VOL. CLXXXII - NO. 11 - INDEX 962

DECEMBER 12, 2005

ESTABLISHED 1878

HEALTH CARE LAW

Modern Corporate Governance

Board members must keep pace with changing nonprofit corporate governance principles

By Steven R. Antico

Corporate governance is that system of rules, policies and procedures through which the board of directors or trustees (Board) of a corporation oversees the affairs of the corporation, performs the Board's designated functions and discharges its fiduciary duties. Legislative and governmental agency intolerance towards Board impropriety and inaction in the for-profit and nonprofit arena have resulted in:

- The passage of Sarbanes-Oxley (SOX), which was designed to ensure effective and independent governance of corporate activities in public companies;
- The adoption of tax legislation, regulations and related guidance, including the adoption of Intermediate Sanctions, and the promulgation of guidance by the Internal Revenue

Antico is a partner with Garfunkel, Wild & Travis of Hackensack. He is a member of the health care, corporate and tax practice groups. Kimberly Kempton-Serra, a law clerk, assisted with the preparation of this article.

Service regarding the continuation of tax-exempt status, conflicts of interest (including a Model Conflicts of Interest Policy for tax-exempt organizations (Model Conflict Policy)), and executive compensation;

- The development of corporate compliance guidelines by the Office of Inspector General of the United States Department of Health and Human Services (OIG) for numerous types of health care providers, including, most recently, as part of a collaborative effort with the American Health Lawyers Association, the publication of "Corporate Responsibility and Corporate Compliance: A Resource for Health Care Board of Directors" (OIG's Compliance and Responsibility Resource); and
- The United States Sentencing Commission's promulgation of standards for compliance and ethics programs for the Board and senior management (Commission Guidelines).

In addition, nonprofit organizations must withstand the scrutiny of the public, actionable through state attorneys general, who increasingly investigate nonprofit organizations to ensure compliance with mission and charter requirements. These legal developments, coupled with mission compliance, while maintaining solvency, are continuing and substantial challenges borne by nonprofit Boards.

The Duty of Care

Board members must adhere to the traditional duties of fiduciaries. The duty of care requires trustees and officers to act in good faith in a manner reasonably believed to be in the best interest of the organization. The standard of care is one that an ordinarily prudent person in a similar position would use under similar circumstances. Decisions made by a Board will be protected by the business judgment rule so long as the relevant standards are met. Generally, courts will not second-guess the business judgment of a Board when decisions are made in good faith, even if such decisions turn out to be wrong.

To satisfy the business judgment rule, a Board must inquire and be fully informed of relevant facts and possess sufficient meaningful information in the oversight of the organization's activities — including financial and compliance activities. In general, reliance on information provided by others must be reasonable under the circumstances, considering such factors as the source of the information, whether the information is a brief summary or an extensive analysis, whether the matter is routine or extraordinary, and the time frame within which a decision is made. SOX, as well as many state laws, recognize the circumstances when relying on information compiled by others is appropriate.

Although SOX primarily targets public companies and only directly applies to nonprofit organizations in

two respects — the treatment of whistleblowers and document destruction — compliance with SOX can limit Board liability. This occurs through the establishment of best practices concerning: (a) Board independence; (b) internal controls regarding financial reporting, record retention, and conflicts of interest; (c) organization executives' accountability for financial reporting; and (d) the encouragement of reporting illegal or unethical behavior through the creation of whistleblower protections.

SOX standards are already applied to nonprofit organizations through OIG guidelines and the security regulations of the Health Insurance Portability and Accountability Act (HIPAA). HIPAA includes many of the same compliance features of SOX and gives the OIG the authority to exclude members of the Board from the health care industry if they knew or should have known about an activity that gave rise to a conviction or exclusion.

Corporate compliance is one area where Board members must take an independent, decisive role and cannot simply rely on others to any great extent. Not only is corporate compliance a major feature of SOX and the Commission Guidelines, it applies directly to nonprofit health care Boards pursuant to the standards set forth in the OIG's Compliance and Responsibility Resource. Corporate compliance in this context includes: (a) development of and adherence to codes of conduct and ethics policies; (b) designation of a chief compliance officer and a corporate compliance committee, if appropriate; (c) implementation of effective education programs for all employees; (d) creation of a process, such as a hotline, for anonymous complaints regarding problems within the organization, and the protection of whistleblowers; (e) development of a response system for allegations of improper activity and the enforcement of disciplinary action against those who violate internal policies; and (f) establishment of independent audit techniques. Boards must have an active role in developing and implementing the compliance tenets above as a means of discharging their duty of care.

Another area where the duty of care requires action by the Board is, surprisingly, homeland security. The re-evaluation of the nation's readiness for large-scale emergencies has prompted the overhaul of the United States' response infrastructure, including the laws that govern emergency procedures. Hospitals and other health care entities, now considered "first responders," must have an emergency preparedness plan, and must understand the legal duties and liabilities that may arise before, during and after a disaster or emergency. The lack of such plans could expose organizations to considerable liability.

Health care Boards, for example, need to know the parameters of governmental authority during a disaster or emergency, such as the quarantine authority and the ability of a public health official to take over a hospital. Hospital Boards must know whether noncredentialed health care providers can render health services in their facility during an emergency and what their liability is concerning such providers. State statutes and regulations will govern the above concerns, and may vary substantially. The New Jersey Emergency Health Powers Act provides the Commissioner of the Department of Health and Senior Services with the power to take over or shut down any health care facility and provides immunity to volunteer health care providers during a public health emergency. Relevant federal legislation includes the U.S.A. Patriot Act, the Homeland Security Act and the Terrorism Risk Insurance Act.

The Duty of Loyalty

The duty of loyalty requires officers and trustees to avoid self-dealing transactions, conflicts of interest and the appearance of conflicts. This duty may be compromised whenever a trustee has a conflict of interest, derives an improper financial benefit from a transaction or usurps a corporate opportunity. If a trustee has a conflict of interest, does not disclose it, and participates in a decision that directly or indirectly benefits the trustee, the duty of loyalty

is violated. The duty of loyalty and duty of care go hand in hand — if the duty of loyalty has not been met, the business judgment rule will not protect the Board's resultant decision.

The establishment of a conflict of interest policy may be a best practice for SOX purposes, but for purposes of continued federal tax-exemption, it is imperative. The Model Conflict Policy contains detailed procedures for addressing conflicts and provides that each Board and relevant committee meeting should produce a record of trustees who disclosed a conflict. In addition, the Model Conflict Policy requires an annual statement, signed by each trustee, officer and Board committee member, affirming that he has received, read, and understands the organization's conflict of interest policy, has agreed to comply with the policy and understands that the organization must only engage in activities which accomplish its tax-exempt purpose. According to the Model Conflict Policy, compensation arrangements and adherence to the organization's tax-exempt purpose should also be reviewed periodically by the Board.

The Duty of Obedience

The duty of obedience is unique to nonprofit organizations and is sometimes viewed as a subset of the duty of loyalty. The duty of obedience requires that the Board effectively carry out the nonprofit purpose of the organization. This duty is accomplished by, among other things, ensuring that fair compensation is paid to executives/employees and fair consideration is conveyed in all business transactions and arrangements.

A nonprofit organization's income and assets must be used for purposes that promote and enhance the organization's mission and cannot be permitted in any respect to benefit any individual or other person who is in a position to exercise control or influence over the organization. This standard is known as the private inurement prohibition. In contrast to private inurement which focuses on "insiders," the private benefit prohibition focuses on the underlying purpose of the organization, and the

spillover benefit to the class of individuals receiving benefits from an organization's exempt activities.

Violation of the private inurement and private benefit prohibitions can result in revocation of tax-exempt status. More likely, however, the IRS would seek to impose intermediate sanctions arising from the excess benefit transaction. Intermediate sanctions are a form of excise tax on (a) insiders, known as "disqualified persons," who receive excess benefits in a transaction with an exempt organization, and (b) on the organization's managers and Board members who participated in those transactions knowing they provided excess benefits. Previously, the imposition of intermediate sanctions ostensibly allowed the tax-exempt organization to avoid the harsh punishment of exemption revocation. Newly proposed IRS regulations, however, seek to clarify the applicability of private inurement and intermediate sanctions to the same transaction, resulting in the imposition of an excise tax on the excess benefit transaction and the possible revocation of tax-exemption as a result of the existence of private inurement.

An exempt organization may pay its employees, agents, and representatives reasonable compensation without creating private inurement, an impermissible level of private benefit, or conducting an excess benefit transaction. Factors to consider in determining whether compensation is reasonable include: (a) compensation levels paid by similarly situated organizations both taxable and tax-exempt, for functionally comparable positions; (b) the availability of similar services in the geographic area; (c) current compensation surveys compiled by independent firms; and (d) actual written offers from similar institutions competing for the services of the disqualified person.

Payments under a compensation

arrangement are presumed to be reasonable, and a transfer of property or the right to use property is presumed to be at fair market value, if: (a) the compensation arrangement is approved in advance by an authorized body of the organization; (b) the authorized body is composed entirely of individuals who do not have a conflict of interest with respect to the compensation arrangement; (c) the authorized body obtained and relied on appropriate data for comparability before making its determination; and (d) the authorized body adequately documents the basis for its determination concurrently with making its determination.

It is also a health care Board's obligation to ensure that effective compliance plans are in place so that the organization's conduct does not trigger the Federal Anti-Kickback Law, the Federal Anti-Referral Law (Stark), and analogous state laws. Under the Federal Anti-Kickback Law, it is a crime to knowingly and willfully solicit, receive, offer or pay any remuneration in return for or to induce referrals or the purchasing, leasing, ordering or arranging of any good, facility, item or service for which payment may be made in whole or in part under a federal health care program. Stark prohibits a physician from making a referral for certain specified "designated health services" that are paid for by the federal health care program to an entity when the physician or an immediate family member has a financial relationship with that entity, unless an exception to Stark is squarely met. If the referral is prohibited, the submission of a claim for payment by the entity that receives the referral is also prohibited. New Jersey's analog to the foregoing laws concerning physicians is the Codey Law, which applies regardless of the type of payer.

The Duty To Monitor

The 1996 Delaware Chancery

Court opinion *In Re Caremark* clarified that the Board has an affirmative duty to monitor corporate compliance. The duty includes a good faith effort by the Board to ensure that a corporate information and reporting system exists, is adequate, and is reasonably designed to allow management and the Board to reach informed judgments. This decision established for the first time director liability based on inaction.

Although not required, a nonprofit organization's establishment of an independent audit committee can enhance the independence of the audit function, and promote consistent financial reporting. An audit committee should have the flexibility to develop and utilize procedures appropriate for the needs and character of the organization. SOX requires a Board to establish an audit committee comprised of independent directors, which means that an audit committee member must not be a paid consultant or advisor to the organization, or receive any fee as compensation for nonboard work from the organization.

Conclusion

To keep pace with changing nonprofit corporate governance principles, Board members should independently avail themselves of the relevant law and standards necessary for them to properly conduct the organization's mission and business, and satisfy their duties. Board members should strive for the establishment of a culture of integrity in their organizations, and demonstrate continuing diligence to implement a system of best practices. Board members must always remain mindful of their four primary duties: care, loyalty, obedience and monitoring, and take affirmative steps to ensure the Board and the organization they serve abide by these principles as well. ■