McDermott Will & Emery

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Corporate Law & Governance Update

A monthly briefing for the Nonprofit Health Care General Counsel

The following developments from the past month offer guidance on corporate law and governance law as they may be applied to nonprofit health care organizations:

WELLS FARGO LESSONS

The recently released independent **investigative report of the Wells Fargo sales model controversy** provides a surprising number of important oversight, structural and reporting lessons for the corporate leadership of health care industry companies.

Primary among these is the potential for performance targets and "sales" goals to incentivize employee behavior that is inconsistent with law or corporate culture. Another important lesson relates to the risk and compliance oversight challenges associated with a decentralized corporate structure. Associated concerns include the effectiveness with which risk is identified, the ability to recognize the materiality of such risk, and the timing and sufficiency of risk reporting to the board.

The report's observations may also encourage boards to move more proactively to address potential risk and legal compliance issues, to require more detail from management in risk-related reporting to the board, and to deal more forcefully with executives who are inadequately responsive to board risk concerns. Perhaps the overarching lesson is for leadership to treat the potential for reputational damage to the corporation with utmost seriousness.

THE RISK INSENSITIVE EXECUTIVE

A significant emerging governance issue is how best to monitor— and influence— the management style of those senior executive officers who by nature are generally insensitive to the risk implications of their initiatives.

As **recent controversies** across multiple industry sectors confirm, executive insensitivity to risk can lead to extraordinary legal, accounting and reputational crises for the organization. The issue extends beyond the chief executive officer to other senior officers (*e.g.*, the chief operating officer, the chief financial officer, the chief information officer) with significant organizational portfolios, and the authority to implement strategic initiatives. Their potential insensitivity to risk can similarly trigger enterprise-level concerns.

The most direct approach is a clear message to executive leadership that risk management is as much of a responsibility of the board, as it is for the leadership team. The board and its senior executives must reach a consensus on the company's risk profile, and how that is to be manifested in corporate strategy. The general counsel, with her fundamental professional responsibility obligations, should be an important participant in any related dialogue.

CLAWBACK CLAUSES

Health system executive compensation committees may wish to reconsider the use of "clawback" provisions in executive compensation agreements. This, given widespread media coverage of the recent **decision by a major financial institution to "claw back" stock awards** to senior executives who were deemed culpable in a recent controversy involving the institution.

"Clawback" is a corporate responsibility-based tool that allows a corporation to recoup compensation awards from executives under certain defined circumstances. Experience suggests that many sophisticated health systems (both for-profit and nonprofit) have adopted some form of clawback in their annual and/or long-term incentive compensation programs, as evidence of "good governance" practices.

The most comprehensive "clawback" arrangements feature two components: the first is a Sarbanes-Oxley type of clawback, which provides for the forfeiture of incentive compensation, paid to the CEO and CFO, if the financial statements on which the pay was based have to be restated due to material noncompliance as the result of misconduct by any employee. The second is a Dodd-Frank type of clawback, which is a mechanical recalculation of the incentive pay (and possible clawback if the resulting recalculated pay is less than the amount of the original payout) if the financial statements are restated for any reason.

Contributed by Ralph DeJong

VIRTUAL-ONLY MEETINGS

Efforts by an influential government official to curb the use of so-called "virtual meetings" (*e.g.*, meetings held exclusively by remote communication such as online access) should cause health systems to monitor more closely the extent to which board and committee meetings are held through the use of technology or other "remote" means.

This effort is **being pursued by Scott Stringer**, the influential New York City Comptroller. His request is being made to the trustees of the five pension funds in the NYC Retirement Systems. His overarching goal is to limit barriers to stakeholder communication in annual meetings, and is not opposed to "hybrid" meetings that combine a "live" meeting with the opportunity for stakeholder participation through remote communication.

Clearly, most state corporate statutes allow for meetings to be held through the use of technology, and such meetings can be very efficient in terms of time and expense. Yet the general counsel, in her role as legal advisor to the board, should be mindful of the potential that "virtual" or other forms of technology-driven meetings could lead to a decline in director engagement, or other indicia of decreased meeting effectiveness.

THE GOVERNANCE AND NOMINATING COMMITTEE

An interesting **new commentary from Ernst & Young** (EY) draws useful attention to the role of the board's nominating and governance committee. While the analysis reflects data drawn from Fortune 100 companies, most of it is highly relevant to sophisticated nonprofit health systems.

The EY commentary focuses on trends affecting the key duties and responsibilities of the nominating and governance committee. These include structural matters such as its core charter and the committee's composition (including the extent of independent directors serving on the committee). The commentary also addresses key duties of the committee, including addressing matters of diversity (across multiple levels), assuring that both the nomination process and the full board composition are consistent with the company's long term agenda, and strengthening the role of the committee in implementing board and individual director evaluation.

The nominating and governance committee is increasingly becoming a critical health system board function. The new EY study could be a useful prompt for more in-depth board discussion of the roles of this key committee. Because most of the committee's duties and responsibilities are inherently legal in nature, the general counsel should be an important contributor to that discussion.

WHITE-COLLAR ENFORCEMENT TRENDS

The health system's audit and compliance committee might benefit from an update from the general counsel on the first significant statements from Department of Justice officials regarding "white-collar" enforcement trends under the Trump administration.

Commenting publicly in recent weeks were both **US Attorney General Jeff Sessions**, as well as **Acting Principal Deputy Attorney General Trevor McFadden** (a Trump Administration appointee). The apparent goal of the presentations was to confirm, with various different levels of detail, the intent of the **new Administration to continue to actively focus on white-collar criminal enforcement**. This, perhaps, to counter initial media suggestions that the new Administration would not prioritize this area. Indeed, both officials confirmed the Administration's continuing commitment to individual accountability for corporate misconduct, as outlined in the well known 2015 "Yates Memo."

Both Mr. Sessions and Mr. McFadden were supportive of corporate compliance initiatives, and referenced as a goal encouraging voluntary compliance with law (*e.g.*, the voluntary FCPA Pilot Program). **Several knowledgable observers** have interpreted these statements as a strong endorsement of continued corporate efforts to assure the effectiveness of compliance programs, codes of conduct and ethics, and related board-driven activities.

FOCUS ON DIRECTOR INDEPENDENCE

Health system board governance committees should expect an increasing public focus on the role of the independent director in corporate governance. This, as we approach the 15th anniversary of the Sarbanes-Oxley Act (July 30), which stimulated the now-longstanding focus on the importance of independent directors as a check/balance to management.

The core premise, that the presence of **independent directors can serve as a prophylactic against fraud** and malfeasance, continues to be tested by the continuing evidence of corporate fraud across industry sectors since 2002. A recent academic study suggests that not only have independent directors been generally unsuccessful in that prophylactic role, in certain instances they have actually been implicated in allegations of corporate fraud. The study authors call on Congress to adopt other measures (*e.g.*, providing shareholders with substantially more authority) to offset perceived failures of the independent director role.

Most health system parent boards reflect control in a majority of independent directors. While the definition of "independence," and the articulation of their specific duties and responsibilities, can be a challenge for both boards and management, they still play an important corporate responsibility role. The general counsel can be an effective boardroom advocate for the continued value of the independent director.

SUPPORTING THE AUDIT COMMITTEE

A recent **speech by SEC Chief Accountant Wes Bricker** provides a series of useful steps to possibly improve the effectiveness of audit committees. While the presentation focused on publicly traded companies, most of the effectiveness recommendations are equally relevant to the audit committees of nonprofit health systems.

Four of Mr. Bricker's recommendations stand out in this regard. First, is the opportunity to improve the effectiveness of audit committees through an increased level of diversity (of thought, and of relevant skills) in committee membership. Second, is the importance of perioidcally assessing the workload of the audit committee to assure its ability to stay current and perform its responsibilties.

Third, is the significant value provided by audit committees exercising their influence over the organizational control environment, through "tone at the top" and other measures. Fourth, is the importance attributed to providing audit committee members with meaningful training and education.

The general counsel plays an important role in serving as principal staff to the committee (together with the CFO or other senior corporate finance officials). It is totally consistent with that role for the general counsel to brief the committee on governance effectiveness measures.

THE DIRECTOR-TURNED-CEO

The wisdom of selecting a sitting board member as the organization's CEO is the subject of the latest **commentary from the Stanford University/Rock Center for Corporate Governance** (always an excellent source of corporate governance guidance for health systems).

The commentary is premised on the core principle that one of the most important fiduciary responsibilities of the governing board is the selection of a qualified CEO. While situations where the board has selected an internal, rather than external

candidate are rare, it is a decision that has been made by several prominent companies over the last decade.

The cited advantages of the "Director-turned CEO" are at least threefold: (1) familiarity with the company and its strategy, business model and risk management practices; (2) cultural fit/personal relationships with the executive team and fellow board members; and (3) independence from current members of the executive management team.

Cited disadvantages include: (1) the extent to which it suggests a lack of board preparedness with respect to executive succession matters; (2) the extent to which it suggests a lack of board preparedness with respect to the diligence necessary for a formal search process; and (3) the potential (as some research suggests) that such appointments are negatively associated with financial performance.

While the Stanford/Rock commentary is focused on public companies, it is nevertheless a useful resource for the talent development and executive search practices of large nonprofit health systems.

MORE ON CORPORATE CULTURE

The board's role in supporting an ethical and mission-driven corporate culture (and the general counsel's role in assisting the board in exercising oversight of culture) continues to be demonstrated by a series of recent developments and controversies.

In the last month, there have been several highly publicized corporate controversies in various different industry sectors (*e.g.*, media, banking, finance, transportation), in which alleged failures of corporate culture resulted in financial harm to the organization (*e.g.*, threats of litigation and ultimate settlements); termination, demotion or change in senior executive employment status; and enormous damage to the organization's reputation and good will.

The areas of suggested cultural breakdown ranged from matters of employee dignity and personal conduct, to a rules-based culture that limited the willingness of employees to respond "outside of the book" to workplace problems.

The challenges facing board oversight of corporate culture were also chronicled in a recent **article in the DealBook feature** of *The New York Times*. The general counsel is well suited to support the board as it addresses these critical, emerging cultural oversight responsibilites.

FOR MORE INFORMATION

For additional information on any of the developments referenced above, please contact Michael at +1 312 984 6933 or at mperegrine@mwe.com; or visit his publications library at **www.mwe.com/peregrinepubs**.

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- Advising the 'Cultural Revolution' in the Boardroom
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