



Corporate Governance – Fiduciary Duties and Related Issues in the Health Care Space

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Introduction

- Firm – Now known as Maynard Nexsen PC
- Speakers
- Topic
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Corporate Governance

- All corporate powers must be exercised by or under the authority of and the affairs of the corporation managed under the direction of its board (except what is reserved in the Articles of Incorporation). S.C. Code Ann. § 33-31-801(a).
- Generally guided by the corporation's basic governance documents.



Governance

Board's Responsibility:

- Establish strategy and monitor performance
- Select and evaluate a management team to carry out policy
- Consider major decisions

Governance

Corporate Officers Have
Separate Role, With
Expectations To:

- Manage day-to-day operations;
- Further the Facility's strategic directives;
- Mitigate risks;
- Control costs;
- Understand the governing laws and the Corporation's policies;
- Educate the Board;
- Forge strategic alliances; and
- Get the job done/accomplish the mission.

Governance Documents

Every nonprofit corporation has governance documents which define and outline the rules and regulations within which the corporation operates:

- Articles of Incorporation
- Bylaws



Governance Documents

Articles of Incorporation

- Corporate name;
- Purpose statement (limited if tax exempt: common business purpose);
- Registered Agent and Registered Office;
- Principle office;
- Designates type of corporation (public benefit; mutual benefit; religious);
- Member vs. Non-member;
- Distribution of assets upon dissolution; and
- Miscellaneous provisions - so long as not inconsistent with the South Carolina Nonprofit Corporation Act ("Nonprofit Act").

Governance Documents

Bylaws:

- Required by the Nonprofit Act;
- Outline the regulation and management of the corporation; and
- Generally set forth the basic governance structure of the of the corporation.

Governance Documents

The bylaws typically state the rules and procedures for the following:

- Maintaining filings with the Secretary of State;
- Defining member rights;
- Holding corporate meetings;
- Voting on actions of the corporation;
- Identifying the # of and electing, appointing or designating directors;
- Appointing officers;
- Establishing committees (standing and ad hoc)
- Maintaining corporate records;
- Indemnifying directors and officers; and
- Other rules/procedures related to governance.

Governance Documents

The bylaws may contain any provision pertaining to the regulation and management of the corporation provided the provision is not inconsistent with the Nonprofit Act or the Articles.

Should be a useful document that you can refer to when questions arise.

Best Practice: flexibility

Directors and Officers as Fiduciaries

Directors and officers are fiduciaries under the law with respect to the corporation they serve.

A Fiduciary

- Acts on behalf of another in a position of trust
- Must act honestly, loyally and responsibly

Duties apply, regardless of compensation

Directors and Officers as Fiduciaries

Officers owe fiduciary duties!!!

Two Fundamental Fiduciary Duties

Duty of Care

Must act with prudence and diligence

Duty of Loyalty

Must put interests of corporation first, ahead of personal interests

Other Duties (Subsumed by the first two)

Duty of Good Faith: Must be scrupulously honest

Duty of Candor: Require full disclosure of conflicts

Duty to ensure organization maintains its tax-exempt status (if applicable)

Duty of Care & Duty of Loyalty

- General standards for officers.
- An officer with discretionary authority shall discharge his duties under that authority:
 - (1) in good faith;
 - (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
 - (3) in a manner the officer reasonably believes to be in the best interests of the corporation, and its members, if any.

Duty of Care & Duty of Loyalty

- General standards for directors.
- A director shall discharge his duties as a director including his duties as a member of a committee:
 - (1) in good faith;
 - (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
 - (3) in a manner the director reasonably believes to be in the best interests of the corporation.

Duty of Care & Duty of Loyalty

- In discharging his or her duties, a director and officer is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:
 - (1) one or more officers or employees of the corporation who the director reasonably believes is reliable and competent in the matters presented;
 - (2) legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the person's professional or expert competence;
 - (3) a committee of the board of which the director is not a member, as to matters within its jurisdiction, if the director reasonably believes the committee merits confidence; or
 - (4) in the case of religious corporations, religious authorities and ministers, priests, rabbis, or other persons whose position or duties in the religious organization the director believes justify reliance and confidence and who the director believes is reliable and competent in the matters presented. S.C. Code Ann. § 33-31-830(b).

Duty of Care & Duty of Loyalty: Good Faith Requirement

A director or officer is not acting in good faith if the director has knowledge concerning the matter in question that makes reliance unwarranted.

A Practical Way to View the Rules

- Am I being *honest*?
- Am I being *loyal*?
- Am I being *diligent*?
- Am I being *forthcoming*?

Business Judgment Rule

Key protection for a board of directors

“Under the business judgment rule, a court will not review the business judgment of a corporate governing board when it acts within its authority and it acts without corrupt motives and in good faith.” Dockside Assn. v. Detyens, 291 S.C. 214, 217, 352 S.E.2d 714, 716 (Ct. App. 1987).

Applies if a decision is made:

- In **good faith**
- Upon **appropriate information**
- In **honest belief** in the corporation’s **best interest**

Effects: If the Business Judgment Rule applies

Directors cannot be held liable for their decisions that result in loss or turn out to be wrong
No judicial second guessing of board decisions

Business Judgment Rule

Focus is on the process, not the results, of a board's decision

The Rule does not apply if a director

- Is not disinterested (conflict of interest or self-dealing)
- Does not do his/her due diligence (not adequately informed)
- Does not make a decision (indifference)

When the rule does not apply, the court will examine the substance of the board's decision

Liability Protection - Exoneration

Exoneration:

- An officer is not liable to the corporation, a member, or any other person for any action taken or not taken as an officer, if the officer acted in compliance with § 33-31-842 (i.e., fulfilled the fiduciary duties).
- A director is not liable to the corporation, a member, or any other person for any action taken or not taken as a director, if the director acted in compliance with § 33-31-830 (i.e., fulfilled their fiduciary duties).

A Practical Way to View the Rules

- **I am not required to have made the “right” or “correct” decision, but I must act with:**
 - **common sense;**
 - **an informed judgment; and**
 - **with good motives**

A Closer Look at the Duty of Loyalty: Conflicts of Interest

Rule: An officer or director must put the corporation's interests ahead of those of the director and third parties

A Closer Look at the Duty of Loyalty: Conflicts of Interest (cont.)

An officer or director must disclose his conflict and all material facts

Conflict of interest transactions

- Are subject to *greater scrutiny* (no Business Judgment Rule)
- May be *voidable*
- May result in *personal liability*
- **Without special approvals, interested directors must prove *fairness***

A Closer Look at the Duty of Loyalty: Conflicts of Interest (cont.)

“An [officer or] director should normally be viewed as interested in a transaction if he or the immediate members of his family have a financial interest in the transaction or a relationship with the other parties to the transaction such that the relationship might reasonably be expected to affect his judgment in the particular matter in a manner adverse to the corporation.”

A Closer Look at the Duty of Loyalty: Conflicts of Interest (cont.)

What constitutes a relationship that may result in a conflict of interest?

- Officer or director has a *material ownership* or other *financial interest* in other party
- Officer or director serves in a *position of control* with other party (director, officer or trustee)

A Closer Look at the Duty of Care: Oversight Responsibility

"All corporate powers must be exercised by or under the authority of and the affairs of the corporation managed under the direction of its board"

Board has oversight authority *and responsibility* over all corporate affairs
No Business Judgment Rule upon failure to oversee or to act due to indifference

A Closer Look at the Duty of Care

Other Issues

- **Must stay informed using all material and available information**
- **May rely on advice and information from officers, employees, committees and experts, if reasonable**
- **Omissions, as well as acts, may breach the duty of care**

Duty of Care (continued)

- Ultimately, it is the responsibility of the Officers and Directors to ensure the organization is complying with all applicable laws
- In health care industry, regulatory environment is exceedingly complex
- Management Teams at Health Care Systems and Hospitals must be aware

Duty of Care (continued)

Is your organization complying with (among other rules):

Stark Law

Anti-kickback Laws

False Claims Laws

HIPAA

Licensing

Medicare Certification

Quality

Case Study

- Case in point: Official Comm. of Unsecured Creditors v. Baldwin (In re Lemington Home for the Aged), 60 Bankr. Ct. Dec. 138 (C.A.3 (Pa.) January 26, 2015)
- A nonprofit nursing home that had been operational for over 100 years came into financial trouble and ultimately declared bankruptcy and shut down, resulting in a lawsuit related to its management and governance in the 10 years prior
 - CEO breached the duty of care: 1997-2004
 - The home was out of compliance with state and federal regs;
 - Cited for deficiencies at 3 times the level of other facilities in the state;
 - “Patient recordkeeping and billing were in disarray”; deficient clinical documentation
 - In final 2 years, 2 patients died under “suspicious circumstances”
 - Investigation showed that CEO lacked qualifications, knowledge of applicable regulations, and ability to direct staff to perform services required
 - CEO breached the duty of loyalty:
 - Did not work full-time but collected a full-time salary while receiving short term disability
 - Made the “self-interested” decision to collect salary she knew she was not earning

Case Study (continued)

- CFO breached the duty of care:
 - Did not prepare financial statements or even maintain a general ledger for over a year;
 - Did not cooperate with a consultant engaged to help save the company;
 - Lied to consultant about records and to the Board about cooperation;
 - Stopped billing Medicare -- failed to bill/collect over \$500K
 - Failed to report \$1.2m in assistance from the state that would have attracted buyers
- CFO breached the duty of loyalty by acting in self-interest:
 - Orchestrated and made a proposal for the sale of the home to a buyer entity in which the CFO would assume the role of new President and CEO without disclosing his role.

Case Study (continued)

- The Board of Directors has “direct supervisory control, authority and responsibility” over the CEO and CFO.
- Directors breached the duty of care: “Heads stuck in the sand”
 - By “failing to take action to remove [CEO] and [CFO] once the results of their mismanagement became apparent.”
 - Allowed the CEO to continue as the Administrator and CEO when:
 - Aware home had deficiencies 3 times other facilities;
 - Received a independent opinion from auditor that Administrator should be replaced due to the number of citations for the facility
 - Sought and obtained a grant for \$178K from a foundation to fund an Administrator search, but did not use the funds for that purpose;
 - Was aware she was working-part time and getting paid full-time and did nothing (illegal for Admin.)
 - Allowed the CFO to continue in his role after being informed he was not keeping appropriate records

Case Study (continued)

- *"This is not a case where directors, acting in good-faith reliance 'on information, opinions, reports or statements' prepared by employees or experts, made a business decision to continue to employ an Administrator whose performance was arguably less than ideal."*
 - *"[T]he Director Defendants received several independent reports documenting Causey's shortcomings and urging that she be replaced."*
 - *"The Director Defendants therefore had actual knowledge of her mismanagement, yet stuck their heads in the sand in the face of repeated signs that residents were receiving care that was severely deficient."*

Case Study (continued)

- Verdict for Damages Upheld in Part
 - Compensatory Damages against CEO, CFO, and Board (joint and several) -- \$2,250,000
 - Punitive Damages
 - CEO -- \$750,000
 - CFO -- \$1,000,000
 - Evidence of self-dealing - The Officers “acted with outrageous motive of pursuing self-enrichment at the expense of the non-profit nursing home to which they owed fiduciary duties”
- Court overturned punitive damage award against Directors finding that they had not engaged in self-dealing like the Officers had

Protections Under SC State Law: “Safe Harbors”

- Directors enjoy **immunity** from suit under S.C. Code § 33-31-834:
 - Stems from tax exempt status (501(c)(3), (c)(6), & (c)(12))
 - Immunity lost when director’s conduct amounts to willful, wanton, or gross negligence.
 - What is gross negligence? When the defendant has failed to exercise a slight degree of care. Osborn v. University Med. Assoc. of MUSC, 278 F.Supp.2d 720, 729-730 (D. S.C. 2003).
 - What is willful, wanton behavior? Whether a tort “is committed in such a manner or under such circumstances that a person of ordinary reason or prudence would then have been conscious of it as an invasion of the plaintiff’s rights.” Id. at 730.
 - Implies conscious wrongdoing by defendant.

Protections Under SC State Law: “Safe Harbors”

- Additional protections under S.C. Code Ann. § 33-31-202(b).
- Unless the articles provide otherwise, no director of the corporation is personally liable for monetary damages for breach of any duty to the corporation or members. However, this provision shall not eliminate or limit the liability of a director:
 - (1) for any breach of the director's duty of loyalty to the corporation or its members;
 - (2) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law;
 - (3) for any transaction from which a director derived an improper personal benefit; or
 - (4) under Sections 33-31-831(COI); 832(Loans); 833(Distributions).

SC State Law Protections

- Note that these statutory protections do not cover officers.



Protections Under State Law

- Statutory Indemnification
 - Mandatory (S.C. Code § 33-31-852)
 - Director is a party to proceeding because of status as a director and has a successful defense on the merits.
 - Permissive (S.C. Code § 33-31-851)
 - Conditions must be met:
 - If a civil proceeding:
 - Conducted him/herself in good faith; &
 - Reasonably believed conduct was in the best interests of the corporation.
 - If a criminal proceeding, no reasonable cause to believe his/her conduct was unlawful.
 - Often times contained in bylaws
 - Must be approved by the Attorney General

Protections under D&O Policy

- Review Current D&O Policy
- Directors and Officers Liability Coverage
- Pays Loss (damages/settlements/judgments/defense costs) on behalf of the Insured Persons
- Maximum aggregate limit
- Applicable Deductible

Tax Law Compliance: Remember the Basis for Your Exempt Status

- Organized and operated exclusively for exempt purpose
- No private inurement
- Compliance reported annually on the 990



Policies are Important

- Written policies help organizations:
 - Demonstrate compliance with applicable laws
 - Implement standards and operate consistently
 - Fulfill their directives
- But, they may hurt you if not followed – unaddressed noncompliance with policies can increase organizational risk

Practical Tip: Example Policies

- Conflict of interest
- Document retention & destruction
- Legal compliance
 - Code of Conduct
 - Compliance officer/Compliance committee/Compliance program
 - Open communication
 - Auditing and Monitoring
 - Investigating complaints and alleged violations
 - Enforcement of disciplinary standards
 - Routine training and education

Policies and Procedures - Compliance Program

- Compliance Program – what is it?
 - Organized program through which a hospital promotes and ensures compliance with applicable government requirements
- A program designed to:
 - Proactively prevent noncompliance with healthcare laws and regulations
 - Identify and resolve potential noncompliance
 - Address specific areas of risk
- According to OIG guidance to hospitals: *“The purpose of compliance policies and procedures is to establish bright-line rules that help employees carry out their job functions in a manner that ensures compliance with federal health care program requirements.”*

Compliance Program

- Directors and officers are ultimately responsible for Compliance Program oversight.
- They should:
 - Be aware of compliance activities
 - Support compliance activities, including by dedicating appropriate resources
 - Stay up-to-date on regulatory changes and enforcement activities for applicable rules and regulations
 - Empower the compliance team and back them up

Practical Tip: Policy Management

- Know your organization's policies
- Review them periodically
- Adhere to them
- Update them as necessary
- Clarify and simplify as may be helpful for users

Unique Health Care Situations

- Health care organizations are more frequently forming joint ventures or affiliations with other organizations
 - This often this involves forming a new entity to carry out the joint mission
- The officers and directors of the “JV entity” are often comprised of the same individuals who work for the JV’s member organizations
- So be aware: those individuals may owe fiduciary duties to the JV entity (in addition to their own member entity)
- At the JV level, decisions may arise where the best interest of the JV conflicts with the best interest of the individual’s member entity—what to do??

Unique Health Care Situations

- Focus has been on fiduciary duties owed by Directors and Officers to their own organization
- But fiduciary duties can apply in other contexts: organizations themselves can owe fiduciary duties to other organizations
 - where one organization has control over the other entity; and
 - The non-controlling entity puts confidence and trust in the controlling entity's judgment and advice
- This can be tricky in the non-profit world, especially in the health care industry where many organizations engage in joint ventures, strategic partnerships, alliances, joint-operating agreements, and other corporate arrangements
- In the for-profit context, courts generally find that a parent corporation does not a fiduciary duty to a subsidiary corporation—part of the rationale is that the interests of the two corporations would be aligned
- But that alignment of interest is not always true in the non-profit world

Unique Health Care Situations (cont'd)

For example, consider a multi-hospital health care system

In a multi-hospital health care system, the interests of the system as a whole may diverge from those of a particular hospital

Some courts around the country have found that a health care system owes a fiduciary duty to its member hospital, where the system:

- Has the power to elect (and remove) a majority of the board of the hospital
- Has the power to oversee key aspects of the hospital's operations
- Involved in the hospital's policymaking and contracts with health insurers

These cases tend to be extremely facts-and-circumstances orientated

Difficult to draw black-and-white rules

Duties of Management to the Corporation

In the for-profit world, the analysis of fiduciary duties is often easier, because the responsibility of the Board and Management Team is crystal clear—i.e., maximize shareholder value. Shareholders are the primary stakeholders

But in the non-profit health care world, that analysis can become complicated. Although the codified standards may be the same for analyzing fiduciary duties, the factors that courts weigh are different, and for nonprofit hospitals, courts will sometimes give consideration to the patients and community served by the hospital as additional stakeholders

Board (and, to a certain extent, the officers) need to focus on:

- Legal compliance
- Mission
- Financial performance

Additional Practical Considerations

- In one case involving litigation between a nonprofit entity (that was an arm of a governmental hospital) and its terminated CEO, a South Carolina court stated that:
 - the standards for fiduciary duty are malleable, and thus, it can be hard for a litigant to prevail at the summary judgement stage.
 - Whether or not a director or officer acted disloyally is often a question of fact
- Nonprofit argued that bad management decisions by a CEO (along with other questionable, self-serving actions) were adverse to the organization and rose to the level of breach of fiduciary duty
- Typically, poor performance alone would not rise to level of breach of fiduciary duty, but combined with other bad facts (breach of employment agreement or policies, misbehavior, wrongdoing, etc.) can make an officer susceptible to a claim from his or her organization
- Officers should take care to avoid these types of claims by being (i) honest, (ii) loyal, (iii) diligent, and (iv) forthcoming

Additional Practical Considerations

Caution:

Officers should avoid the mentality that they ought to:

- refrain from disclosing relevant information from the Board
- be overly selective in the information disclosed to the Board

Officers need to keep their Board adequately informed!

TAKE-AWAYS

ACT ON INFORMATION
PROVIDED!!!

DON'T STICK YOUR HEAD
IN THE SAND.



TAKE-AWAYS

Board members and officers should:

- BE INFORMED -- be aware of and briefed regularly on financial performance, compliance, and mission
- TAKE ACTIONS IN THE BEST INTERESTS OF THE CORPORATION
- Approve and oversee the Code of Conduct and Compliance Program;
 - Regular compliance updates to the Board and Officers;
 - Regularly evaluate and update all components of the Compliance Program;
 - Regularly review the adequacy of compliance resources;

Questions?

Thank
You