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Key Nonprofit Corporate Law and Governance Developments in 2013

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For a year seemingly dominated by Affordable Care Act topics, 2013 nevertheless included a substantial number of corporate law and governance developments of great significance to nonprofit hospitals and health systems. In the midst of consolidation, enforcement and other health-care industry pressures, corporate governance remained a key legal feasibility consideration for nonprofit organizations.

As might be expected, the leading 2013 trends reflected an industry in transition, with health systems responding to Affordable Care Act implementation issues, the reshaping of competitive forces, and the broader consolidation of the nonprofit health provider sector. Within that context, the 2013 trends speak to (a) new and fundamentally different governance challenges (and opportunities) confronting the health system board; (b) correspondingly more complex board agendas (and pressures on the level of director engagement); (c) heightened expectations of board oversight on risk and compliance matters; (d) enhanced scrutiny of the board's exercise of business judgment and good faith; and (e) continued close oversight from federal and state charity regulators.

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As in the past, certain 2013 judicial decisions, enforcement actions and similar events arising from other elements of the nonprofit sector (e.g., higher education, disease-focused charities) also proved relevant to nonprofit hospitals and health systems.

Based on these trends, our ''Top Ten'' list of major nonprofit corporate law and governance developments for health care providers in 2013 is as follows:

1. Continued Sector Consolidation.

The rapid pace of consolidation of the nonprofit health care sector continued in 2013, as many providers sought the benefits perceived to arise from collaboration or combination with other, typically larger organizations.

As in recent years, much of the transaction activity was between nonprofit hospitals and health systems. In addition to transactions involving the integration of operations and assets, some nonprofit systems pursued (nonintegrated) regional shared services collaboratives as a means of achieving efficiencies and economies without divesting ownership or control. The level of activity involving asset sales and joint ventures between nonprofit hospitals and proprietary companies continued at a consistent pace. Some larger nonprofit systems began to pursue unique partnerships with insurance companies. Generally speaking, these types of collaboration have been viewed favorably by the credit rating agencies.[1]

State charity officials have been very involved in the oversight and (often) review and approval of such transactions. These officials are generally aware of the economic and regulatory forces prompting health sector collaborative activity. Depending upon the particular state, review of a particular transaction may be triggered by hospital-specific statutes and regulations (including those regulating for-profit conversions); state nonprofit corporation laws; and state charitable trust laws. In general, the concerns of the charity officials include the consideration received for a change of control of a provider; the process by which the transaction was reviewed by the board (including its diligence, its reliance on qualified advisers, and the absence of conflicts of interest); and the impact of the transaction both on

[1] ''Joined at the Hip: Not-for-Profit Hospitals Pursue Virtual Mergers,'' Moody's Investors Service Special Comment, Aug. 28, 2013; *Healthcare@moodys.com*.

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the subject charitable assets and on the community (e.g., access to care).[2]

Several major 2013 developments highlight the types of pre- and post-closing problems that can arise from hospital mergers and other forms of collaboration.

One such example relates to the potential for post-closing disagreements between the merger participants on the implementation of specific terms and conditions. On Jan. 24, a Missouri court determined that an HCA affiliate had breached certain capital commitments made in its 2003 acquisition of the Health Midwest system.[3] The court awarded $162 million in damages to the nonprofit community foundation created at the time of the acquisition. The foundation had been granted the right to enforce the post-closing commitments made by the HCA affiliate in the definitive agreement. The court also appointed an accountant to evaluate whether the HCA affiliate had actually satisfied charitable care commitments made in connection with the definitive agreement.

Another example was the Minnesota attorney general's decision (announced March 26) to investigate the circumstances involving the possible combination of Fairview Health Services, Minneapolis, and Sanford Health system, of Sioux Falls, S.D.[4] The attorney general pursued public hearings to address the state's concerns that control of a major Minnesota nonprofit health system (including the University of Minnesota's research and teaching hospital) could be transferred to an out-of-state nonprofit health system. Following the hearings, which were intensely critical of the proposed transaction, Sanford Health withdrew from the proposal.

Projection for 2014: As completed mergers ''mature,'' there will be a gradual increase in litigation intended to force a buyer to fulfill specific definitive covenants and commitments allegedly agreed to in the merger document. It also is likely that some states may intervene in merger discussions to prevent what they perceives to be an imbalance of consideration or a breach of the charitable trust.

2. Enforcement Activity.

Despite budget-driven funding limitations in many states, there were in 2013 a series of high profile attorney general enforcement actions of particular relevance to hospitals and health systems.

For example, a settlement involving the New York attorney general demonstrated the willingness of the state to hold nonprofit directors personally accountable for breach of fiduciary duty.[5] The settlement arose from an investigation of a nonprofit corporation and a series of interested party transactions involving its chief executive officer that was determined to involve excess market benefits. The state concluded that the board failed to exercise the required degree of oversight in connection with those transactions, and imposed severe penalties on the CEO and on individual board members. In particular, the directors agreed to a future ban on nonprofit board service in the state.

The May 8, 2013, settlement between several Hershey School entities and the Pennsylvania attorney general similarly offers important governance lessons to nonprofit health systems.[6] The settlement concluded a lengthy investigation of controversial real estate transactions entered into by the charity. The attorney general concluded that Hershey board members had not violated their fiduciary duties in connection with any of the implicated transactions or other actions. However, the Hershey entities agreed to reform their existing governance practices in multiple ways, to address attorney general concerns with respect to board formation, composition, conflicts, transaction review, travel and entertainment expense and other topics.

On Dec. 13, the New York attorney general announced a $7.7 million settlement with a nonprofit foundation affiliated with a for-profit education company, for the alleged misuse of charitable assets.[7] The state had alleged that the charitable foundation developed course materials that the for-profit company intended to sell commercially. The settlement also included a series of governance reforms intended to ensure that the charity's assets would not be used for the private benefit of the for-profit company.

The authority of the state attorney general to intervene in the affairs of nonprofit organizations was further demonstrated in the case of the August Wilson Center for African American Culture, in Pittsburgh.[8] The center, housed in an architecturally significant building in the downtown area, had encountered financial and operating problems since its opening, with an $11 million bank loan for construction completion costs being a particular burden. After the lender brought a foreclosure action in September, the attorney general successfully pursued a state court action for an accounting of the center's affairs, going back to 2006. Subsequently, on Nov. 1, the state court appointed a conservator for the center; in essence, removing the center's board from its traditional role. An action to institute an accounting and to appoint a conservator over corporate finances is a recognized power available to attorneys general and most often is applied to preserve nonprofit assets from dissipation.

Each of these enforcement actions offers useful guidance to nonprofit health systems on the willingness of state charity officials to investigate conduct that may be inconsistent with nonprofit law, and to apply a wide range of financial and equitable penalties in order to address perceived breaches of fiduciary duty.

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[2] ''Nonprofit, For-Profit Hospital Mergers Increasing, State Regulators Say,'' *BNA's Health Law Reporter* (Oct. 31, 2013), Vol. 22, No. 43, at p. 1627. (22 HLR 1627, 10/31/13)

[3] ''Greater Kansas City Health Care Foundation Awarded $162 Million in Ruling Against HCA,'' *Bloomberg BNA's Health Care Daily Report*, Jan. 31, 2013.

[4] Tony Kennedy and Jeremy Olson, ''Minnesota AG to investigate Sanford's Proposed Takeover of Fairview,'' *StarTribune.com*, March 26, 2013; *http://www.startribune.com/local/200065931.html*.

[5] *http://www.ag.ny.gov/press-release/ag-schneiderman-obtains-55-million-settlement-self-dealing-leading-not-profit-provider*.

[6] *http://www.attorneygeneral.gov/uploadedFiles/Press/05082013%20Hershey%20Trust%20Agreement.pdf*; Bob Fernandez, ''Settlement Ends Hershey Trust Probe,'' May 10, 2013; *http://articles.philly.com/2013-05-10/news/39144622_1_hershey-charity-board-members-golf-course*.

[7] *http://ag.ny.gov/press-release/ag-schneiderman-secures-77-million-settlement-pearson-charitable-foundation-support*.

[8] Timothy McNulty, ''Pennsylvania Attorney General Seeks Audit of August Wilson Center,'' *Pittsburgh Post-Gazette*, Oct. 31, 2013; *http://www.post-gazette.com/local/city/2013/10/31/Pennsylvania-Attorney-General-Kathleen-Kane-seeks-audit-of-August-Wilson-Center/stories/201310310259*.

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Projection for 2014: State charity officials can be expected to continue their willingness to pursue action against nonprofit corporations, their officers and directors, in situations in which they believe charitable assets may be placed at risk. Most often, these actions involve allegations of conflicts of interest/self dealing, private use of charitable assets, defalcation, and either gross negligence or bad faith by nonprofit directors and officers.

3. Board Composition.

New perspectives, commentaries and public policy positions on nonprofit board composition were particularly prevalent in 2013. Because of the increasing governance challenges confronting nonprofit health systems, these new perspectives are relevant to health system governance, especially to the extent they may inform the position of state and federal charity officials.

A leading example was the May 8 release by Moody's Investors Service of the Special Comment, ''Not-for-Profit Hospitals: The Pursuit of Value.'' [9] This report emphasizes the creation of value through ''the cultivation of informed leadership.'' Specifically, a health system's ability to develop new leaders with competencies in all of the new areas into which health systems are diversifying is an increasingly important factor in the credit rating analysis. This would include adding leaders with ''atypical skills and backgrounds'' (e.g., IT, engineering, manufacturing, corporate consolidation) to help respond to changes in health industry dynamics. Expertise in quality of care, population health and wellness, digital enterprise and cybersecurity also are increasingly sought.

Also notable was a new proposal from the American Bar Association to revise section 8.02 of the Model Business Corporation Act.[10] The revisions are intended to allow a board to establish qualifications for directors that are reasonable in nature and cannot be used for entrenchment purposes by incumbent directors. In particular, the ABA proposes that qualifications may include not having been subject to specified criminal, civil or regulatory sanctions or not having been removed as a director by judicial action or for cause. Obviously, nominating committees also are interested in establishing other, industry-specific qualifications. The ABA's action is relevant to health systems because of the close similarity between provisions of the Model Business Corporation Act and the Model Nonprofit Corporation Act—on which many state nonprofit laws are based.

A new academic report analyzed the cost/benefit analysis of appointing ''prestigious'' individuals to an organization's governing board.[11] The report concluded that the benefits of adding prestigious directors often are offset by the associated costs—e.g., conflicts with established work routines, disruption to existing status hierarchies and the potential for tumultuous boardroom behavior.

The proper composition of specialty committees such as audit and risk were the focus of various academic studies, best practices reports and shareholder activity in the proprietary sector. For example, a particular academic study suggested that compliance with Sarbanes-Oxley Act-related audit committee standards may be insufficient to assure that committee members have the proper background (e.g., finance, accounting or legal) for service.[12] A separate ''best practices'' report on audit trends proposed that companies provide greater transparency on the composition of the audit committee, and the methods used to select committee members.[13]

In addition, a variety of academic reports and public policy papers issued in 2013 discussed, but failed to resolve the question of whether term limits for board members are appropriate.[14]

Projection for 2014: Nonprofit health system boards will move aggressively toward more competency-based boards. Efforts to nominate directors with skill sets well matched for emerging operational needs will be accelerated.

4. Executive Compensation.

Consistent with prior years, nonprofit sector executive compensation generated several noteworthy developments in 2013.

On Dec. 19, a comprehensive new report on nonprofit executive compensation was released by the Massachusetts attorney general.[15] The report was based on a survey of 25 large Massachusetts nonprofit organizations, and addresses not only base compensation, but also associated benefits and perquisites. The report acknowledges that the surveyed organizations approached the compensation process ''with care and attention'' to the IRS ''rebuttable presumption'' requirements, but observes that such processes have not served to restrain CEO compensation or its growth. The attorney general urges nonprofit boards to increase their review of compensation arrangements, with closer focus on external transparency, severance arrangements and consideration of internal pay equity issues. The report is one of the most comprehensive state government surveys of charity organization executive compensation in recent years.

Nonprofit health systems were included within the list of over 400 tax exempt organizations selected to receive from the IRS a ''compliance check letter'' with respect to the sponsorship of so-called ''top hat'' plans (nonqualified deferred compensation arrangements for select groups of highly compensated employees, man-

[9] ''Not-for-Profit Hospitals: The Pursuit of Value'': Moody's Investors Service Special Comment, May 8, 2013; *Healthcare@moodys.com*.

[10] Corporate Laws Committee, ABA Business Law Section, ''Changes in the Model Business Corporation Act—Proposed Amendments to Section 8.02 Relating to Qualifications for Directors and Nominees for Directors''; *The Business Lawyer*, Vol. 68, No. 3 (May, 2013).

[11] ''Research Examines Impact of Prestige on Corporate Board Dynamics,'' Penn State Smeal College of Business, Oct. 18, 2013; *http://news.smeal.psu.edu/news-release-archives/2013/october/research-examines-impact-of-prestige-on-corporate-board-dynamics*.

[12] *The Effect of Audit Committee Expertise on Monitoring Financial Reporting*, The Harvard Law School Forum on Corporate Governance and Financial Regulation, *http://blogs.law.harvard.edu/corpgov/2013/12/05/the-effect-of-audit-committee-expertise-on-monitoring-financial-reporting/*.

[13] The Audit Committee Collaboration, ''Enhancing the Audit Committee Report: A Call to Action,'' November 2013; *http://www.auditcommitteecollaboration.org/*.

[14] *See, e.g.*, Joann S. Lublin, ''The 40 Year Club: America's Longest-Serving Directors,'' *The Wall Street Journal*, July 16, 2013.

[15] *http://www.mass.gov/ago/docs/nonprofit/ceocomp/ec-review.pdf*.

agers, directors and officers), specifically created to comply with Code Section 457(b).[16] The compliance check process is expected to continue through Sept. 30, 2014. The IRS goals in the compliance check process include learning more about the operation of nongovernmental 457(b) plans; verifying that individual plans comply with applicable Internal Revenue Code requirements (and are not offering the more favorable features available to governmental 457(b) plans); identifying areas of plan noncompliance; and recommending ways to remove barriers to compliance.

A Harvard School of Public Health survey demonstrated what it described as the lack of correlation between hospital quality of care performance and CEO compensation.[17] According to the survey, the average CEO compensation was approximately $600,000, with CEOs in the highest 10 percent earning approximately $1.7 million. Compensation was higher at institutions with high patient satisfaction ratings and advanced technology.

Issues of internal pay equity were presented with the Sept. 18 release by the SEC of proposed (and controversial) new rules concerning executive pay equity.[18] The Dodd-Frank Act requires publicly held companies to report the ratio of total compensation of the CEO to median employee total compensation. The proposed rules implementing this portion of the act are highly controversial and have received significant attention from certain stakeholder groups (e.g., organized labor). The Dodd-Frank Act is not, of course, applicable to nonprofit organizations but health system compensation committee discussions may nevertheless wish to discuss the underlying public policy interest with respect to potential disparities in executive and employee compensation. (This is an issue that is indirectly addressed in the Massachusetts report, referenced above.)

As noted above, the IRS's Final Report on Tax Exempt Colleges and Universities Compliance Project focused heavily on executive compensation issues, and on the appropriateness of comparability data used by the institutions to support compliance with the IRS's rebuttable presumption of reasonableness.[19]

Finally, on March 23, 2013, a federal district court decision granted a nonprofit health insurance company's motion for summary judgment, that it be excused from performing under an incentive compensation arrangement under the ''doctrine of legal impracticability'' (i.e., a government investigation into the executive compensation arrangement with the health insurance company).[20]

Projection for 2014: It remains to be seen whether other state attorneys general will follow the lead of Massachusetts in examining the executive compensation paid by leading nonprofit organizations in the state. That notwithstanding, it can be expected that continued pressure will be placed on both the reasonableness of the total compensation packages paid to health system executives, as well as on the role of the executive compensation committee in determining reasonableness and in considering matters of internal pay equity.

5. Compliance Oversight.

The responsibilities of health system directors with respect to oversight of compliance related matters were the subject of a series of developments in 2013.

One of the most significant was the Sept. 3 opinion of the South Carolina attorney general, which concluded that officers and trustees of Tuomey Healthcare system could not be indemnified for penalties associated with a May 8 jury verdict against the health system for violations of the federal Stark law and the False Claims Act in connection with certain of its physician employment arrangements. It was in the context of that verdict that the opinion was sought from the attorney general on the ability of a charitable, nonprofit corporation (Tuomey) to indemnify its officers and trustees from litigation associated penalties. According to the attorney general, indemnification would be inappropriate where the officers and directors had not been named as defendants and thus were not compelled to pay damages (as was the circumstance at the time the opinion was issued). In other words, the indemnification issue was not ''ripe.''

However, the opinion created the potential for misunderstanding to the extent that it suggests that South Carolina charitable trust law may actually ''trump'' state nonprofit corporation law as to the prevailing standard for director liability (i.e., ''simple negligence'' v. ''gross negligence''). The attorney general's opinion applies South Carolina law, and arose in the context of a contentious enforcement action involving highly unusual facts. However, the issuance of the opinion, regardless of its limited application, has served to prompt a broader discussion at the board and compliance committee levels as to directors' access to indemnification and insurance protections—particularly in situations where, like the *Tuomey* case, the role of the board in its oversight of physician contracting arrangements was a matter raised by the government.[21]

''It is Tuomey's own management and board who are responsible for permitting the damages and penalties to amount to the level ultimately found by the jury. Tuomey's executives and management decided to throw caution to the wind and refused to terminate the contracts until the first jury declared them illegal.'' [22]

The settlement of a criminal case involving billing practices at a prominent North Carolina health system also offered several important compliance oversight de-

[16] *http://op.bna.com/hl.nsf/r?Open=psts-9g2jhq*.

[17] Genevra Pittman, ''Hospital CEO pay not tied to quality of care: study,'' Reuters, Oct. 15, 2103; *http://in.reuters.com/article/2013/10/14/us-hospital-quality-care-idINBRE99D0MA20131014*.

[18] Securities and Exchange Commission Proposed Rule Pay Ratio Disclosure (*http://www.sec.gov/rules/proposed/2013/33-9452.pdf*).

[19] ''Colleges and Universities Compliance Project,'' May 2, 2013; *http://www.irs.gov/Charities-&-Non-Profits/Colleges-and-Universities-Compliance-Project*.

[20] *Milnes v. Blue Cross and Blue Shield of Vermont*, D. Vt., No. 1:11-cv-49.

[21] The attorney general opinion can be located at *http://www.scag.gov/wp-content/uploads/2013/09/mcelveen-t-iii-os-9622-9-3-13-nonprofit-board-indemnification-tuomey.pdf*; the quotation can be located at *Drakeford v. Tuomey Healthcare System, Inc.*, Reply in Support of United States' Motion For Entry of Judgment Under The False Claims Act (Filed June 24, 2013) (Pages 20, 21).

[22] *Drakeford v. Tuomey Health System, Inc.*, Reply in Support of United States' Motion For Entry of Judgment Under the False Claims Act (Filed June 24, 2013) (pp. 20, 21).

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velopments.[23] First is the fact that the government chose to pursue the case (which arose from allegations of improper Medicare billing practices) on a criminal, rather than civil basis—a highly unusual approach. Second is that the various components of the settlement—including the deferred prosecution agreement, the government's memorandum to the presiding judge, the judge's initial unwillingness to approve the deferred prosecution agreement, and the related corporate integrity agreement—all offer the boards a window into the manner in which the government approaches criminal prosecutorial decisions in health care. Indeed, the deferred prosecution agreement included an admission of corporate responsibility for the criminal conduct. Also notable from the settlement is the importance attributed to the health system decision to revise its corporate compliance program in numerous ways in accordance with the advice it received from a consultant, who was engaged to examine the effectiveness of that program.

Relevant compliance and risk oversight developments also arose in the context of several other interesting sources. Notable among these was a report from the National Association of Corporate Directors (NACD) and the accounting firm McGladery LLP that addresses the important issue of mitigating ''information asymmetry;'' i.e., the potential for an information gap between management and the board on risk issues.[24] The report identifies the leading warning signs of ''board information risk'' as insufficient time for the board to analyze risk issues; board-level information overload; management's negative impression of the board; management reluctance to report risk; lack of risk expertise on the board; and a poor CEO/chair relationship. The report also makes a series of recommendations on how best to reduce this risk, including recruiting qualified independent directors with a diversity of skill sets, positioning the chair to work with management to shape board information flow, appropriate access to the management team, effective use of executive session practice, and thoughtful timing of committee meetings.

Similarly, a recent report issued by the consulting firm Deloitte addressed the relationship of internal audit to corporate antifraud and compliance activities, generally.[25] According to Deloitte (and its review of member survey data from the Institute of Internal Auditors (IIA)), the internal audit function at a broad cross section of public, private and nonprofit companies fails to comply with the IIA's International Standards for the Professional Practice of Internal Auditing. Deloitte describes this as a ''corporate governance breakdown.'' Among the most frequently violated standards are those designed to prevent management override of internal controls, and reducing fraud and corruption risk.

Projection for 2014: The extent to which the health system board provides effective oversight over compliance matters in general, and physician integration in particular, will be a major governance concern.

[23] *See, e.g.*, Peregrine and Buchman, ''WakeMed's Compliance Oversight Lessons,'' *Health Lawyers Weekly*, March 1, 2013.

[24] *http://www.nacdonline.org/Resources/Article.cfm?ItemNumber=7910*.

[25] *http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/DeloitteForensicCenter/us_dfc_corporate_governance_breakdown_print-friendly_111513.pdf*.

6. Charitable Trust.

Two disparate 2013 developments served to revive the long-dormant, but potentially unresolved conflict between the proper application of charitable trust laws to nonprofit corporations, particularly in the health care sector.

Nonprofit hospitals and health systems are organized for charitable purposes under state nonprofit corporation codes, and their assets are irrevocably dedicated to such purposes. Nevertheless, some states maintain statutes or case law that can be interpreted as applying charitable trust principles to nonprofit corporations. This can create significant confusion as to the applicable legal standards that are to be applied to these corporations and their officers and directors, as trust law standards in most states differ significantly from both general corporate standards and the state's nonprofit corporation law. Indeed, the application of corporate law or trust law standards to hospitals and health systems in certain circumstances has been the subject of periodic litigation over the last 25 years, and remains a controversial legal topic. It is in that context that the following two 2013 developments stand out.

First is the previously referenced decision of the Minnesota attorney general to intervene in the proposed combination of Fairview Health Services, Minneapolis, with Sanford Health system, of Sioux Falls, S.D., in a corporate collaboration in which the South Dakota system was potentially to have obtained control of the Minnesota system (including the University of Minnesota's research and teaching hospital).[26] While most state nonprofit corporation laws would on the surface appear to allow such a combination, the attorney general referenced charitable trust principles as the basis for holding public hearings on the proposed transaction. The hearings focused in part on the attorney general's concerns that representatives of the Fairview board of directors conducted private negotiations with Sanford representatives ''without the benefit of the public's input regarding a matter of such sweeping consequences as it relates to the control of the University health system, the quality of health care for Minnesota patients, and our State's economy and international prestige.'' [27]

In a letter announcing the holding of hearings, the attorney general referenced ''Queen Elizabeth's Statute of Charitable Uses of 1601'' (and no more recent authority) as the jurisdictional justification for her inquiry. Sanford Health withdrew from the proposed transaction shortly after the initial round of public hearings. The Fairview-Sanford situation demonstrates the confusion that can arise when charitable trust laws are used to investigate or challenge negotiations or transactions between two private nonprofit corporations that have been authorized by the boards of directors of those corporations and which transactions do not purport to amend in any way the charitable purposes (e.g., to provide hospital and health care services).

A second important charitable trust development arises from the South Carolina attorney general opinion, referenced in Section 5, above. As discussed above, the opinion arose from a federal whistleblower-based litigation against the Sumter, S.C., health system that

[26] *See Footnote 4, supra*.

[27] *http://www.keloland.com/classlibrary/page/news/files/Merger%20Letters.pdf*.

resulted in the jury verdict that the system violated the Stark law and the False Claims Act in connection with certain of its physician employment arrangements.

The attorney general analyzed the issue under both the state nonprofit corporation act and the state charitable trust code. It noted that Tuomey is a private nonprofit corporation subject to the South Carolina Nonprofit Corporation Act and that Section 33-31-834 of the South Carolina Code provides immunity from suit to directors, trustees or members of the governing board of nonprofit corporations, absent conduct that amounts to willful, wanton, or gross negligence. Moreover, it specifically cited the case of *Osborn v. University Medical Associates of the Medical University of South Carolina*, 278 F. Supp. 2d 720 (D.S.C. 2003) which upheld this test for director liability. Nonetheless, the attorney general also decided to discuss the applicability of the trust code—which it interpreted as requiring trustees of a charitable trust (to which it found Tuomey subject) to administer the trust in good faith, ''as a prudent person would,'' and appearing to invoke a simple negligence test to impose liability on the Tuomey directors.

As noted above, the attorney general ultimately concluded that Toumey could not appropriately provide indemnification, because the issue was not ''ripe.'' Somewhat curiously, the opinion went on to comment that if the Tuomey officers and trustees were subsequently determined to have breached their fiduciary duties under corporate or trust law, indemnification would be unwarranted.

As to the core conclusion—that the indemnification issue was not ''ripe''—the opinion is consistent with established law relating to the indemnification of nonprofit officers and directors. As a public policy matter, most state corporation law statutes permit indemnification, recognizing that absent such protection capable persons would refuse to serve, act in an overly cautious manner or be reluctant to defend themselves against groundless claims. Yet, indemnification payments must be based upon actual claims against officers and directors.

As to the secondary conclusion—that indemnification would be unwarranted if the Tuomey officers were subsequently determined to have breached their duties under corporate or trust law—the opinion creates the potential for misunderstanding and mischief. This is because, as noted above, the standard for establishing board member liability is more rigorous under corporate-based ''gross negligence'' standards than under the ''prudent person'' (simple negligence) standard that appears applicable under South Carolina trust law. Indeed, the opinion appears to suggest that South Carolina trust law may actually ''trump'' South Carolina nonprofit corporate law with respect to the prevailing standard of liability for directors of nonprofit corporations—in direct contravention of the nonprofit corporation law. Such an interpretation, based on the general concept that charitable corporations hold their assets in trust for charitable purposes and ignoring the clear distinction between trustees and directors, could conceivably expose board members of South Carolina nonprofit corporations, deemed as charitable trusts, to a much greater risk of personal liability exposure: one based on a determination of simple negligence.

In this regard, the opinion unfortunately serves to revive the somewhat dormant dispute as to whether nonprofit corporations, and their officers and directors, should be held to the standards and requirements of both nonprofit corporation law and charitable trust law, even to the extent that their provisions are inconsistent or conflicting. The continuation of this dispute can only serve to create confusion among nonprofit boards in ''charitable trust'' states as to the applicable threshold for personal liability.

Projection for 2014: Given the highly unusual facts associated with these two cases, and the fact that in neither instance was the charitable trust issue litigated to verdict, it is unlikely that either will have any direct ''spillover'' impact on other arrangements and transactions. However, the potential exists for attorneys general to pursue charitable trust arguments against health systems and their officers and directors under similar circumstances, particularly when the facts are controversial.

7. IRS Oversight.

The nonprofit sector has traditionally valued, and benefitted from, a regulatory partnership on corporate law and governance issues between state charity officials and the IRS's Exempt Organizations Division. That partnership continued in 2013 with a variety of enforcement and educational developments from the IRS, the internal and congressional investigations associated with Section 501(c)(4) status notwithstanding. During the year, the IRS was the source of series of survey, audit and educational developments addressing health system corporate and governance matters.

For example, the IRS is pursuing a plan to examine the governance practices of 200 I.R.C. Sec. 501(c)(3) charitable organizations (including hospitals and health systems).[28] The examination is based on its analysis of over 1,300 governance ''checksheets'' IRS agents completed during their examination of such organizations. The new examination process is intended to provide a statistically valid organizational sampling, and to gather additional information with respect to the relationship between governance and tax compliance. This examination initiative highlights two important factors for general counsel—first, the internal reference value of the IRS governance checklist and, second, the continuing interest of the IRS in charity governance.

On April 25, 2013, the IRS released its final report on its ''Tax Exempt Colleges and Universities Compliance Project,'' an industry-wide review similar to what the IRS pursued in prior years with respect to charitable hospitals.[29] Report findings and observations most relevant to hospitals and health systems were those with respect to unrelated business income, and executive compensation. Indeed, the report contains an important lesson for health system compensation committees to be more vigilant in assuring the appropriateness of comparability data used to support executive compensation decisions. The IRS was critical of how many colleges and universities used inappropriate comparability data to support compliance with the rebuttable presumption of reasonableness.

On Aug. 2, 2013, the IRS released a series of ''FAQs'' on Form 990 reporting obligations for tax exempt orga-

[28] *http://www.irs.gov/Charities-&-Non-Profits/Governance-and-Tax-Exempt-Organizations-%E2%80%93-Examination-Materials*.

[29] *http://www.irs.gov/Charities-&-Non-Profits/Colleges-and-Universities-Compliance-Project*.

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nizations. A specific FAQ release is dedicated to responses arising under Part VI (''Governance, Management and Disclosure'').[30] Among the FAQs are several that relate to board policies, director independence and disclosure of the Form 990 to the full board.

An unexpected flurry of materials on governance related topics emerged from the IRS in late 2013.[31] The IRS released thousands of pages of internal training materials that, individually and collectively, provide guidance to health system general counsel on matters relating to tax exemption compliance matters. Among the released documents were the first externally released ''Continuing Professional Education Textbook'' in many years; an IRS training document addressing 501(c)(3) and 509(a) topics; a training manual that explains determination policies for 501(c)(3) exemption applications, and an undated slide presentation used as training material on the application of exemption standards for a broad variety of health industry enterprises and ventures. The documents were released by the IRS in response to an FOIA request from the publishing company *Tax Analysts*.

Projection for 2014: The IRS cannot realistically be expected to return in the near future to its prior level of enforcement activity and educational guidance. That notwithstanding, the role of the IRS in addressing significant tax exemption, Form 990 and intermediate sanctions-related controversies cannot be dismissed—whether such action is conducted in private throughout the audit and settlement process, or in the public domain.

8. Donor/Donee Relationships.

Health systems that derive revenue from charitable donations should note with interest the 2103 increase in litigation involving disputes between donors and the charitable organizations to which they have made gifts. Interest in these types of controversies rose in the health care sector following country singer Garth Brooks' successful 2102 litigation against Integris Canadian Valley Hospital alleging that the hospital breached its contract with Brooks by failing to build a women's center honor of his late mother, a project to which he had made a large donation.[32]

For example, a July 19 feature in *The Wall Street Journal* highlighted the importance of careful drafting in gift agreements to provide clarity with respect to intent but also flexibility to address unforeseen needs. The specific endowment, to Long Island Hospital in Brooklyn, was intended by the donors ''to be held in perpetuity and the income only to be used for general purposes''. However, the hospital met with financial distress and the endowment was ultimately used (with judicial approval) to secure loans, purchase and rehabilitate a building and cover medical malpractice claims.[33]

Two of the more interesting matters were controversies arising from naming rights associated with charitable gifts. In one matter, Georgetown University law alumni Scott Ginsberg had agreed to donate $5 million toward the construction of a fitness center that would bear his name. Subsequent to the gift, Ginsburg settled an SEC insider trading proceeding. Ginsburg later pledged an additional $11 million gift to the law school. However, the fitness center was not constructed and in March 2013, Ginsburg filed suit seeking the return of his donations.[34]

A similar matter related to the decision of Florida Atlantic University to sell naming rights to its football stadium to a private company that operated prisons.[35] While the proposed payment was substantial (reportedly $6 million), the arrangement was subject to substantial public criticism and over 60 organizations formed a coalition to oppose the naming rights arrangement. Ultimately, the prison operating firm chose to withdraw from the arrangement in April 2013.

A more traditional controversy was the litigation relating to the commitment of the Reed Foundation to make a $2.5 million donation to the Franklin D. Roosevelt Four Freedoms Park in New York City. As part of the gift arrangement, the park agreed to carve ''recognition text'' at a specific location near a bust of the former president, located in the park. The park later reneged on that commitment, and the foundation sued, seeking specific performance. In a May 2013 decision, the New York Supreme Court held for the foundation, on the grounds that the time for the park to have expressed its esthetic concerns was during the gift negotiations and not after it had applied the money.[36]

A related controversy involved the application of a 1927 gift from a group of private individuals to Columbia University to develop an Italian cultural heritage residence. Many years following the gift, the Italic Institute brought a complaint alleging that some of the programs offered in connection with the residence were inconsistent with donor intent and supported negative stereotypes of Italian-Americans. On June 14, 2103, the New York Supreme Court dismissed the litigation, holding that the plaintiffs lacked the necessary standing to pursue the litigation.[37]

Collectively, these cases reflect both the increasing complexities of philanthropic giving and the willingness of plaintiffs to pursue litigation against charitable donees to enforce provisions of charitable gift arrange-

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[30] *http://www.irs.gov/pub/irs-tege/Form990PartVIFAQs_071113.pdf*.

[31] Chuck O'Toole, ''IRS Releases EO Training Documents following Tax Analysts Lawsuit,'' Tax Analysts, Nov. 8, 2013; *http://www.taxanalysts.com/www/features.nsf/Articles/31996690C52E2C0585257C1D007ABDFF?OpenDocument*.

[32] *http://www.cbsnews.com/news/garth-brooks-awarded-1-million-in-hospital-lawsuit/*.

[33] Anupreeta Das, ''A Buffett Fortune Fades in Brooklyn,'' *The Wall Street Journal*, July 19, 2013; *http://online.wsj.com/news/articles/SB10001424127887324263404578614183479259720*.

[34] David Lee, ''Donor Sues Georgetown for $7.5 Million,'' *Courthouse News Service*, March 6, 2013; *http://www.courthousenews.com/2013/03/06/55472.htm*.

[35] Greg Allen, ''FAU's Stadium Naming Deal Turns Into PR Disaster,'' npr.org; *http://www.npr.org/2013/04/03/176104596/company-withdraws-naming-rights-offer-for-fau-stadium*.

[36] *Matter of Reed Foundation v. Franklin D. Roosevelt Four Freedoms Park, LLC*, 2013 BY Slip Op. 03191 (May 2, 2013).

[37] Chris Dolmetsch, ''Columbia University Wins Dismissal of Italian House Lawsuit,'' *Bloomberg News*, June 18, 2013; *http://www.businessweek.com/news/2013-06-18/columbia-university-wins-dismissal-of-italian-house-lawsuit-1*.

With respect to footnotes 32-37, the authors also wish to acknowledge Jack B. Siegel, Charity Governance Consulting LLC, ''What's Been Going On: Recent Developments in the Nonprofit Sector,'' presented to the Oct. 7, 2013, NAAg/NASCO Annual Meeting.

ments. They also serve to underscore the importance attributed to efforts of nonprofit hospitals and health systems to monitor the manner in which charitable gifts are solicited and applied.

Projection for 2014: Hospitals and health systems should anticipate an increase in donor-donee disputes, especially as they refocus many of their operational efforts away from a strictly ''patient bed tower'' focus and begin to apply their energies and resources towards a more diverse set of outpatient and other initiatives and partnerships better designed to address the challenges and opportunities of the ACA.

9. Financial Distress.

The rapidly consolidating nonprofit provider sector and the implementation of the ACA are creating significant financial pressures for many hospitals, particularly those that have been unable to align with a hospital or health system partner. For these organizations, the prospect of financial distress looms. For that reason, the May 30, 2013, decision of the U.S. District Court for the Western District of Pennsylvania in connection with the bankruptcy of the nonprofit retirement/nursing facility Lemington Home, has particular significance.[38] In that case, the court applied the doctrine of ''deepening insolvency'' and breach of fiduciary duty rulings to the home's officers and directors.

The home was an historically prominent facility serving the African American community of Pittsburgh. The home had, over time, encountered financial difficulties, leading to insolvency in 1999, and eventual closure of the home and commencement of voluntary Chapter 11 bankruptcy proceedings. In this case, breach of fiduciary duty and deepening insolvency actions were initiated by an official committee of unsecured creditors.

The federal district court granted a summary judgment motion of the officers and directors, on the basis that the business judgment rule and the doctrine of *in pari delicto* precluded any fiduciary duty exposure, and that the absence of evidence of fraud precluded any claim for deepening insolvency. This summary judgment ruling was vacated by an important 2011 decision of the U.S. Court of Appeals for the Third Circuit, which remanded the case for trial. In its ruling, the Third Circuit held that there remained in dispute material issues under all of the claims; that Pennsylvania law recognized ''deepening insolvency'' as a cause of action, and that the business judgment rule was unavailable in the presence of negligence. The subsequent trial resulted in a jury verdict and both damages against 13 of the 15 formed board members of the home and two of the former officers, with respect to the deepening insolvency and breach of duty claims (including punitive damages against certain individuals).

In the 2013 ruling, the federal district court determined that sufficient evidence existed to support the verdicts, on the ground that the officers and directors violated their duty of care owed to the home and contributed to the home's deepening insolvency. The elements of fraud necessary to support a deepening insolvency claim arose from the board's decision to delay a bankruptcy filing; commingling home funds with those of an affiliated entity; continuing to do business with vendors despite the home's insolvency; and transferring home assets to an affiliate after the filing of the bankruptcy petition. Among the conduct ultimately determined to have constituted negligence/breach of fiduciary duty included failing to ensure that the home was properly managed (auditors' warnings notwithstanding); allowing board functions to devolve into ''disarray''; failing to be attentive to indications of operational and financial problems; and possibly encouraging the transfer of home assets to an affiliated legal entity.

While it arose under highly unusual facts, the Lemington Homes case is an indicator of potentially harsh treatment that can be afforded to officers and directors in connection with matters of institutional financial distress. Further, it is an indication that courts in some states will indeed recognize a cause of action for ''deepening insolvency'' even though Delaware, among other states, has declined to do so. The case also suggests that boards of financially distressed institutions may have more to fear in terms of breach of fiduciary duty exposure from a highly motivated committee of unsecured creditors, than from the state attorney general.

Projection for 2014: The *Lemington* rulings will assume particular relevance in 2014 should there be an increase in the number of financially distressed nonprofit hospitals. The harsh rulings of the *Lemington* courts may embolden creditors' committees involved with financially distressed hospitals to take a similarly aggressive approach with respect to fiduciary conduct.

10. Best Practices.

A common goal of many nonprofit health system boards is to maintain a level of performance consistent with established governance best practices. While this is an admirable goal, it requires the health system general counsel to closely monitor the evolution of public policy statements, professional and bar guidelines, association directives and similar sources for examples of what may rise to the level of ''best practice.'' There is no one, all-encompassing statement that serves as the definitive template for nonprofit health system boards. While the Panel on the Nonprofit Sector's 3004 ''Principles'' document is an important reference point, it is intended to apply to a broad cross section of nonprofit organizations and does not by design address many of the important governance concerns facing more organizationally and financially sophisticated nonprofit health systems, for example. For that reason, the following 2013 developments are worthy of note, to the extent that they help inform boards of perspectives on leading governance practices.

For example, a series of high profile academic, public policy statements and industry reports were released throughout the year to address board level gender gap concerns. These include, but are not limited to, a Stanford Business School survey on the pathways for women to join boards;[39] the appointment of women as board members of leading companies;[40] and media re-

[38] *Official Comm. of Unsecured Creditors ex rel. Lemington Home for the Aged v. Baldwin*, W.D. Pa., No. 2:10-cv-800, 5/17/13, 2013 BL 130234 (22 HLR 806, 5/30/13).

[39] David F. Larker and Brian Tayan, ''Pioneering Women on Boards: Pathways of the First Female Directors''; *http://www.gsb.stanford.edu/sites/default/files/35_Women.pdf*.

[40] *See, e.g.*, Vindu Goel, ''Twitter Appoints Marjorie Scardino as First Female Board Member,'' The New York Times, Dec. 5, 2013*; http://bits.blogs.nytimes.com/2013/12/05/twitter-appoints-marjorie-scardino-as-first-female-board-member/?_r=0*.

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ports commenting on data that indicate that companies with the highest percentage of women directors outperform companies with the lowest percentage.[41] These, and similar developments, serve to focus greater public attention on matters of gender diversity in the boardroom. This is likely to place greater pressure on health system board nominating committees to identify qualified women candidates for board positions. The current focus on tapping directors with skill sets well matched for the evolving health system environment (e.g., information technology, digital enterprises, population health and wellness; quality of care; cybersecurity) may provide a unique opportunity to address gender diversity issues in the near term.

As noted above, a new report from NACD and McGladrey LLP provides a series of well-refined recommendations on how boards can address concerns associated with ''information asymmetry; i.e., the potential for an information gap between management and the board on risk issues.''[42]

On a related matter, health system boards and senior management are becoming increasingly aware of the need to be more sensitive to the ethical and professional challenges and expectations placed on the general counsel. Over the last several years, these challenges and expectations have arisen in part through amendments to state bar rules of professional conduct relating to ''reporting up'' obligations, and also to issues with respect to reporting relationships with the compliance officer. In that regard, a new survey released by the Health Care Compliance Association and the Society of Corporate Compliance and Ethics[43] is of potential interest. The survey results reflect broad support for the long-standing perspective of compliance officers that a risk of conflict of interest is created when the compliance officer is directed to report to the general counsel. The issue of the overall relationship between the general counsel and the compliance officer continues to attract debate, and continues to be an issue requiring governance monitoring.

Along similar lines is a Dec. 10 report released by the Association of Corporate Counsel (of which many health system general counsel are members).[44] The report surveyed almost 700 general counsel, as well as a broad cross-section of public company directors, CEOs, ''legal futurists'' and executive recruiters. The report examines the evolving role of the general counsel/chief legal officer and anticipates increased contributions in terms of business and strategic advice expected from those positions in the future. The report also confirms the substantial value attributed by boards to the legal and compliance counseling role of the general counsel.

Several new reports and studies provide guidance on the composition and operation of audit committees. For example, the important new report from the ''Audit Committee Collaboration'' (a policy-oriented venture of several leading U.S. governance organizations) focuses on audit committee reporting and, specifically, greater transparency with respect to the audit committee's roles and responsibilities.[45] A recently published academic survey examines the impact of industry expertise on the effectiveness of the audit committee in monitoring the financial reporting process, and argues for appointing to the audit committee more individuals with specific industry expertise.[46]

A new ''Blue Ribbon Commission'' report also issued by NACD addresses the importance boards should attribute to talent development at both the executive and board levels.[47] The primary theme of this report is that the board is increasingly obligated to assure that executive leadership has effective talent both in place, and in the ''management pipeline.'' Interesting observations of this report include that the pool of experienced senior management and executives is shrinking, that talent development has increased as a leading boardroom priority over the last five years, and that talent/human capital is becoming a more significant focus in financial analysis and valuation decisions. The report contains a strong recommendation that directors make a critical evaluation of the organization's hiring philosophy. All these are factors of relevance to the hospital and health system sector.

Finally, NACD's ''Governance Challenges: 2013 and Beyond'' offers a comprehensive review of strategic challenges for boards arising from new environmental risks.[48] While prepared principally for proprietary companies, many sections of the report are highly relevant for sophisticated hospitals and health systems. This is particularly with respect to issues requiring near-term strategic focus. The report's recommendations on effectively balancing the strategic planning roles of the board and management, on audit committee priorities, and on the board's risk oversight obligations, all have broad practical application to nonprofit hospitals and health systems.

Projection for 2014: General counsel will need to be attentive to an increasing flow of ''best practices''—type policy documents addressing governance topics of relevance to sophisticated nonprofit health systems.

11. Honorable Mention

Other 2013 corporate law and governance developments that merit attention by nonprofit hospitals and health systems include:

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[41] Bill Roth, Having Women on Corporate Boards Increases Profits and Sustainability, *http://www.triplepundit.com/2013/07/women-on-boards-directors-increase-profits-sustainability/*.

[42] *See Footnote 24, supra*.

[43] Survey, ''Should Compliance Report to the General Counsel?'' *http://www.corporatecompliance.org/Resources/View/ArticleId/908/Should-Compliance-Report-to-the-General-Counsel.aspx*.

[44] The Center for the Study of the Legal Profession at Georgetown University Law Center and the Association of Corporate Counsel, ''*Skills for the 21st Century General Counsel*''; *http://www.law.georgetown.edu/news/press-releases/report-explores-changing-role-of-general-counsel.cfm*.

[45] Audit Committee Collaboration; ''Enhancing the Audit Report-A Call to Action''; *http://www.pwc.com/us/en/pwc-investor-resource-institute/assets/pwc-enhancing-the-audit-committee-report-a-call-to-action.pdf*.

[46] *http://blogs.law.harvard.edu/corpgov/2013/12/05/the-effect-of-audit-committee-expertise-on-monitoring-financial-reporting/*.

[47] National Association of Corporate Directors, Blue Ribbon Report on Talent Development, Oct. 15, 2103; *http://blog.nacdonline.org/2013/10/blue-ribbon-commission-report-on-talent-development/*.

[48] National Association of Corporate Directors, ''Governance Challenges 2013 and Beyond'' June 18, 2013; *http://www.nacdonline.org/Resources/Article.cfm?ItemNumber=7048*.

- The enactment of the New York State ''Nonprofit Revitalization Act,'' with its sweeping changes to existing corporate law provisions;[49]
- Delaware's decision to amend its corporation law to allow the so-called ''benefit corporation'' to be chartered in the state;[50]
- The broad-based governance changes adopted by Penn State University in response to the ''Freeh Report''; [51]
- Several Delaware decisions which provide a more practical description of board conduct that arises to the level of ''bad faith''; [52] and
- New congressional focus on the manner in which nonprofit organizations report incidents of defalcation on the Form 990.[53]

Conclusion

2013 was a year in which developments in corporate law and governance, as applied to nonprofit hospitals and health systems, continued apace. Of particular significance were the increased level of regulatory interest in governance practices of nonprofit organizations, evolving pressures on nonprofit system structures, closer scrutiny on the business judgment of nonprofit board members, and increased state involvement in scrutinizing business transactions of nonprofits.

Collectively, these developments confirm continuing interest in the application of nonprofit and charitable trust law concepts on a variety of public and private levels. Counsel to such organizations should continue to be mindful of identifying nonprofit corporate law as a principal legal issue when conducting any material legal analysis for a health care client.

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[49] ''Nonprofit Revitalization Act Signed into Law,'' Dec. 19, 2013; *http://www.ag.ny.gov/press-release/ag-schneidermans-nonprofit-revitalization-act-signed-law*.

[50] Andrea Gates Sanford, ''Delaware's New ''Public Benefit Corporations,'' July 17, 2013; *http://www.spcwa.com/delawares-new-public-benefit-corporation/*.

[51] Integrity monitor cites university's momentum in newly released report, Dec. 6, 2013; *http://progress.psu.edu/*.

[52] *See, e.g.*, Puda Coal, C.A. No. 6476-CS at 23 (transcript); *Rich v. Chong*, C.A. No. 7617-VCG at 31, n.138.

[53] *Joe Stephens* and *Mary Pat Flaherty*, ''Lawmakers press IRS nominee on reports of charity theft, call for greater oversight''; *The Washington Post*, Dec. 12, 2103; *http://www.washingtonpost.com/politics/lawmakers-press-irs-nominee-on-reports-of-charity-theft-call-for-greater-oversight/2013/12/12/46e42d6c-637a-11e3-aa81-e1dab1360323_story.html*.

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