A New Conflicts of Interest Primer

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Key Board Takeaways

- Does the board have a modern approach to identifying conflicts that takes into account the evolution and diversification of the healthcare industry?
- Is the board's conflicts policy sufficient to monitor emerging conflicts?
- Do board members monitor the facts associated with major health system conflicts controversies?
- Does the board have an effective process for evaluating conflicts disclosures?

The hospital and health system sector has experienced several important and widely publicized conflicts-of-interest controversies in the last several months. They have resulted in resignations of officers and directors, implicated matters of individual and organizational reputation, and suggested collateral self-dealing concerns. In so doing, they have heightened the concern about board member conflicts with legislatures, regulators, and the media.

These controversies provide a useful opportunity to refresh board members' awareness of proper conflict-of-interest management—i.e., to review "what it's all about." This includes, but is not limited to, the types of arrangements that give rise to conflicts of interest, the continued adequacy of the board's conflicts policies, and appreciation by officers and directors of their relevant fiduciary obligations.

This article provides a "primer" from which hospital and health system boards can pursue their "conflicts refreshment."

Focus on loyalty. Director obligations concerning conflicts of interest arise within the context of the bedrock fiduciary duty of loyalty. This duty obligates the director to exercise his/her corporate authority in good faith and in the best interests of the organization—as opposed to the director's own interests or the interest of another entity (e.g., the constituency that may have selected the director or who the director may otherwise represent). As it relates to conflicts of interest, the duty of loyalty incorporates responsibilities with respect to disclosure, evaluation, and management of potential and actual conflicts of interest.

It's a matter of law. The duty of loyalty (and its provisions regarding conflicts of interest) isn't some "warm and fuzzy" concept of governance best practices. It is a legal obligation. Fiduciary duties such as those pertaining to care and loyalty arise under principles of common law, and in certain states within specific provisions of the corporation code (some of which contain specific "presumption-shifting" exceptions grounded in reasonableness). Similar prohibitions against self-dealing also arise under state and federal regulation. Thus, it is that state courts, the state attorney general (as to non-profit organizations), and federal courts and regulators have authority to evaluate conflicts-laced transactions.

The fundamental analysis. The goal of conflicts and anti-self-dealing laws and policies is to ensure that directors don't use their position—including voting rights (and any special influence within the boardroom)—for their personal advantage. To achieve this goal, directors must be vigilant to arrangements that create the potential for conflicts, and try to avoid them when possible. And when they do arise, the following analysis should be applied: Is the nature of the director's interest in the arrangement of such personal significance that it could reasonably be expected to exert an influence on the director's judgment when voting on the arrangement?

Why we care. Violations of conflicts-of-interest-related obligations can have serious consequences for the organization, and for the individual director. For example, courts will harshly judge breaches of loyalty, especially in the context of non-profit corporation board service. Third parties (e.g., a regulator, a corporate member, or constituents in a derivative action) may be able to challenge the validity of a business arrangement that is the byproduct of conflict. Conflicts of interest can lead to significant reputational damage to individual directors and to the organization. The presence of conflicts can also be a "red flag" to regulators of the potential for other legal violations.

Disclosure is the key. Having a conflict of interest does not, in and of itself, violate the duty of loyalty (except perhaps where a director pursues an arrangement knowing it to create a potential conflict for the organization). Rather, the greatest risk of breach arises when the director fails to timely and adequately disclose the existence of the arrangement to the board. Such failure frustrates the board's right to be made aware of the arrangement, to determine whether indeed it creates a conflict of interest, and to identify whether the conflict can be managed. The board has a right to know when a director may be acting under dual loyalties.

What's different now? The seismic change enveloping the healthcare industry is having an enormous impact on the conflict-of-interest process of hospital and health system boards. For example, there are new concepts of who—or what—is a competitor. There's a much broader scope of investment interests that could potentially influence a fiduciary's decision making. Dualities of interest once considered non-threatening may now present significant conflict concerns. The personal relationships of fiduciaries are now fair game for conflicts consideration. And the public, media, and regulators are much more aware of conflicts than before. These prompt a more expansive approach to disclosure.

Process counts. The fiduciary duty focus on conflicts is not entirely related to the duty of loyalty. Even the most precise loyalty compliance can't support the effectiveness of a conflict-of-interest policy if the manner in which the board/committee evaluates individual disclosures is not consistent with the duty of care. Key factors include the delegation of board authority to a committee responsible for addressing conflicts, composing the committee with independent directors, staffing the work of the committee with key officers (e.g., general counsel, chief compliance officer), setting standards by which disclosures will be analyzed, and applying the statutory rebuttable presumption where available.

More than once per year. The completion of the annual conflicts disclosure questionnaire should not be the "sum and substance" of the conflicts review process. There needs to be a mindset amongst directors that prompts them to periodically update their disclosures as circumstances arise in the year (conferring as necessary with the general

counsel or compliance officer). More particularly, the board should distribute supplemental conflicts disclosure questionnaires to address conflicts issues arising from critical proposed business transactions or arrangements, such as a merger/acquisition or a major investment. A conflicts policy that is not updated throughout the year may be insufficient to protect the organization's interests.

Management plans sometimes work. Many boards may reasonably move forward with conflict-of-interest-related arrangements under the supervision of specially crafted conflicts management plans. This approach is typically applied when non-conflicted board members are satisfied with the reasonableness of the terms and conditions of the arrangement (conflict notwithstanding) and believe that the arrangement offers substantial (e.g., "compelling") benefit to the organization and its mission. Management plans are written documents that provide for close monitoring of the arrangement post approval to make sure the perceived benefits are achieved without inappropriate personal benefit. The plans also provide for termination of the arrangement under specific circumstances.

Appearances count. Arrangements that only create the appearance of a conflict (as determined by the conflicts committee) may nevertheless create two significant risks for the organization and the individual director: 1) the risk of reputational harm arising from media reporting on the arrangement (reporting may apply a more superficial, "common sense" analysis), and 2) the potential for regulatory inquiry based on such media or whistleblower reporting of the arrangement—and the significant legal costs that can be incurred in responding to such an inquiry. Thus, the conflicts committee should also monitor the impact of director interests that only create the appearance of a conflict.

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