A Passive Governance Approach Will No Longer Work

Anne M. Murphy*
ArentFox Schiff

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*These slides were prepared by Michael W. Peregrine, Partner. McDermott Will and Emery

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Goals of the Presentation

- To confirm the historical separation between board and management roles
- To underscore the importance of the board/management "partnership"
- To review the law's expectations of director engagement with management
- To "flag" areas of concern where engagement may "fall short" of expectations
- To provide practical guidance on how proper engagement can be demonstrated

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"In a Nutshell"

Now, more than ever before, the law expects corporate directors to engage in the vigorous and informed oversight of the business. A passive approach to governance responsibilities will be viewed with scrutiny. Yet this need not disrupt an appropriately structured board/management relationship and enhanced board engagement.

In Other Words…

The board and management relationship is designed to be a partnership of sorts, working collegially in support of the organizational mission. It's not intended to be an adversarial relationship and shouldn't be, as long as both parties understand their respective duties, and those required of the other party. It is also supported by enhanced director engagement in the duties of the board.

A Starting Place: The Basic Duties of the Board and of Management

Core Duties of the Board

1. Selection and compensation of a competent CEO.
2. Delegation to, and vigorous oversight of, management in the responsibility for day-to-day corporate affairs.
3. Selection of Independent Auditor and assurance of integrity of financial statements.
4. Adoption of corporate culture of ethics and legal compliance.
5. Oversight of strategic planning development and implementation.

Core Duties of the Board (cont'd)

6. Shape governance structure and leadership of the board.
7. Develop and implement executive compensation and succession policies.
8. Develop and maintain legal compliance and risk management programs.
9. Engage as appropriate with consumers of corporation; proper "corporate citizen".
10. Deal fairly and equitably with employees.

Core Duties of Executive Management

1. Operate the corporation by delegation from board.
2. Develop and implement strategic planning.
3. Identify, evaluate and manage strategic risks.
4. Develop operational plans and budgets.
5. Prepare accurate, transparent financial reports.
6. Support organizational culture of ethics and legal compliance.
7. Manage enterprise and related risks.

What This Means to the Relationship Between the Board and the Executive

Relationship Between the Board and the Executive

A. The Proper Governance Role of the Board Within the Framework

1. "Active, informed, independent and assertive stewardship of the charitable mission.“
2. Thorough understanding of operations, business, industry sector necessary for effective performance of duties.
3. Exercise of "constructive skepticism" in the directors' supervisory role; a "confrontational climate" is not required nor is desirable.
4. Informed decision-making based upon appropriate level of reporting and information flow from management.

Relationship Between the Board and the Executive (cont'd)

5. Crucial role in establishing "Tone at the Top" and assuring proper "Corporate Citizenship".
6. Not desirable for directors to try to manage the corporation directly and comprehensively.
7. Inherent limitations on the abilities of outside directors to assure corporate responsibility.
8. Specific expectations/duties of the board—what the corporate documents provide.
9. Assuring alignment between operations, strategy, executive compensation – and mission.
10. Responsibility for long-term viability of corporation.

Relationship Between the Board and the Executive (cont'd)

B. Effectively Managing the Distinction Between "Governance" and "Management" and Related Roles
   1. Fundamental authority to delegate day-to-day management to competent executives.
   2. Ability to rely upon advice and recommendations of management, subject to exercise of oversight.
   3. "Active stewardship" and "constructive skepticism" do not mandate an adversarial relationship with management.
   4. Critical importance of establishing clear "lines of authority" between governance and management.

Relationship Between the Board and the Executive (cont'd)

5. Critical importance of adequate management-to-board reporting and information flow.
6. The undesirable consequences of a confrontational board room climate.
7. "Micro governance": the dangers to the director and to the corporation from crossing "the thin gray line".
8. Appropriate for governance to serve as "sounding board", and as a support resource, to senior management to extent it does not compromise their independence. This is the distinction between being a "monitor" and not a "manager", of corporate operations.

The Fundamentals

A. Perceived Shortcomings in the Exercise of the Oversight Responsibility of the Board; *i.e.*, "Fault Lines" in the Governance Model.

1. Failure to devote adequate time and attention to discharge oversight responsibilities; *e.g.*, inattentiveness to corporate affairs.
2. Excessive reliance on executive management; e.g., relying almost exclusively upon senior executive officers (and advisors they select) for information and guidance about corporate affairs.

The Fundamentals (cont’d)

3. Excessive deference to executive management; i.e., overly dependent upon and overly passive with respect to senior executive officers (especially the CEO).
4. Failure to exercise "constructive skepticism."
5. Failure to ask questions when suspicions are aroused – or should be aroused; *e.g.*, Pause with "yellow flags"; Act with "red flags."

The Fundamentals (cont’d)

B. Liability Standards

1. Bad Faith
2. "Gross Negligence"
3. “Negligence”
4. “Deepening/Contributing to Insolvency”
5. Charity Officials Practice
6. Public Policy

The Fundamentals (cont'd)

C. Typical Defenses/Protections

1. Good Faith (e.g., application of Best Practices)
2. Business Judgment Rule
3. Advice of Counsel/Experts
4. State Liability Shields (Non-Tort Based)
5. Indemnification
6. D&O Insurance

"Passive" is a Four-Letter Word

passive

adjective **US**
/ˈpæs.ɪv/ **UK** /ˈpæs.ɪv/
passive *adjective* (BEHAVIOR)

- often disapproving
  not acting to influence or change a situation; allowing other people to be in control

Who Cares About This

State Attorneys General; Internal Revenue Service; State Secretaries of State; Department of Justice; Rating Agencies; Accreditation Agencies; SEC; Creditors' Counsel; Bondholders; Unsecured Creditors; Donors…

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And Directors Have More on their Plates

One of the most significant, yet discreet, governance developments of the pandemic era has been the expansion of corporate directors' oversight obligations. This expansion is ultimately more the byproduct of evolving third-party expectations that directors be attentive to a larger universe of issues than before. It will impact how directors perform their duty of care in the future.

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How Directors Can Reject Passivity and Become More Engaged

Step One: Mutual Respect

Executive leadership must recognize that the law holds board members to specific duties and responsibilities, to be performed within the context of a fiduciary relationship. The board must understand that management has specific delegated responsibilities and that "oversight" does not license "interference".

Step Two: Lines of Authority

The board and executive leadership should set clear guidelines, to the extent possible, on tasks, initiatives and decisions that (i) the CEO can pursue on his/her own initiative; (ii) are to be ratified by the board after initiated; and (iii) require prior board approval before being initiated.

Basic Levels of Engagement

- Regular attendance at meetings
- Limits on other board service and other external distraction
- Preparation for board activities
- Meaningful participation in board, committee activities
- Industry familiarity
- A collegial board/management culture supportive of open and forthright communications

Secondary Levels of Engagement

The law perceives the board as the "last line of defense" against fraud, mismanagement and potential material organizational risk. Board members should be educated on how to identify and respond to the "yellow" and "red" warning flags of such risk.

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Reorienting the Board/Management Dynamic

It is vitally important that senior executive officers view board members (i) not only as resources/sounding board on board agenda items, but also as (ii) seasoned advisors who have the right (and are expected to) pursue issues with management and otherwise independently identify areas of concern.

It is similarly critical to prevent a culture in which leadership is willing to rebuke directors who do not share its views.

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The Importance of Information Flow

As recent Delaware decisions have noted, the independence and exercise of informed oversight by directors will be enhanced by increasing the flow of material information, updates on mission-critical risks, and relevant analysis to directors.

Ad hoc reporting by management on mission critical risks is unlikely to be considered sufficient for board oversight purposes.

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Exercise of Constructive Skepticism

One of the enduring messages of the Sarbanes-Oxley Act, and the resulting emphasis on corporate responsibility, is that directors should abandon the passive role they may have been satisfied in playing, and instead adopt a new governance culture emphasizing the exercise of "constructive skepticism" and an active, independent oversight role.

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Definition of Constructive Skepticism

Directors exercise "constructive skepticism" through a boardroom culture that encourages directors to ask incisive, probing questions regarding key decision-making and oversight issues, and requires accurate, forthright answers to those questions.

Definition of Constructive Skepticism (cont'd)

Constructive skepticism should be viewed as different than acting as a "devil's advocate". It does not require board members to adopt an adversarial relationship with senior management.

Definition of Constructive Skepticism (cont'd)

Constructive skepticism rejects a culture of passivity and excessive deference to management.

It encompasses the director leveraging his/her diversity of experience and common sense, and raising to management, as appropriate, relevant, well-formed questions-all in a respectful, positive and collegial manner.

Conclusion

In today's complex and demanding health care industry, governance regulators will expect directors to discharge their duties with full engagement. The elements of such full engagement are readily achievable and are consistent with a balanced, collegial partnership between the board and management.