The Board’s Fiduciary Role:
Legal Responsibilities of Health Care Governing Boards
About the Authors

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About the Center for Healthcare Governance

The Center for Healthcare Governance is a community of board members, executives and thought leaders dedicated to advancing excellence, innovation and accountability in health care governance. The Center offers new and seasoned board members, executive staff and clinical leaders a host of resources designed to progressively build knowledge, skills and competencies tailored to specific leadership roles, environments and needs. In partnership with the American Hospital Association.
The Board’s Fiduciary Role: Legal Responsibilities of Health Care Governing Boards
Overview
Serving on a hospital governing board has long been an honor and a privilege. However, intense scrutiny of governance in all sectors, prompted by the Sarbanes-Oxley legislation and the governance reform initiatives that followed, has left some board members questioning whether board service is an honor they can accept.

The Board's Fiduciary Role: Legal Responsibilities of Health Care Governing Boards provides a clear, straightforward explanation of the basic legal duties and obligations of boards that govern nonprofit health care organizations. The publication discusses issues such as what it means to govern on behalf of stakeholders, the importance of understanding the corporate purpose, the difference between managing and governing and the basics of board accountability.

It explores in-depth the three primary legal duties of a nonprofit governing board—the Duty of Care, the Duty of Loyalty, and the Duty of Obedience—and provides practical guidance on how these duties can best be fulfilled.

The publication also considers how these duties apply to several key board responsibilities, such as:
• oversight of legal and regulatory compliance,
• upholding the national mandate to improve health care quality and patient safety,
• physician relationships and competition,
• safeguarding the organization’s charitable assets, and
• protecting the hospital’s credit rating.

Key questions are posed throughout to help board members better understand their obligations and determine how well their boards are discharging their responsibilities in several important areas.

This publication can be a useful resource for both current and prospective board members. It can be used as part of new trustee recruitment efforts and orientation programs as well as for board continuing education programs and leadership retreats. It also can serve as a reference for all board committee chairs and board officers as they plan for and guide board activities.

As authors Fredric J. Entin, Janice A. Anderson and Katherine S. O’Brien conclude, “It is now more important than ever for nonprofit board members to demonstrate that the public’s confidence in nonprofit governance is justified.” This publication is an important resource to help boards do just that.
Introduction

For decades, professional and community leaders have served with distinction on the boards of nonprofit hospitals and health systems. Board membership is an honor bestowed on individuals with genuine concern for the well-being of others. More recently, however, board members may question whether they are able, or even want to, accept the honor. This is because the honor of nonprofit governance is accompanied by the responsibility to govern effectively, and with this responsibility has come increasing public, legal and governmental scrutiny. The financial scandals and failings in the for-profit world have made household names of Enron, WorldCom, and Global Crossing and have raised the public’s awareness of the role of corporate boards and the immense responsibilities that these boards have for the corporations they govern. Today, conversations about corporate governance are common, not only in boardrooms, but at cocktail parties, the grocery store and around the water cooler.

Understandably, the questions raised by the scandals in for-profit boardrooms have spilled over to nonprofit boardrooms as well. The most widely known response of government to Enron and other for-profit corporate debacles was the enactment of Sarbanes Oxley¹ ("SOX"). For nonprofit boards, SOX has simply added to the long-standing legal principles guiding their activities. Years before the enactment of SOX, the legal duties governing hospital boards already had been clearly defined. Although most of the provisions of SOX do not apply to nonprofit boards, it has raised the bar on performance and accountability for all boards and has brought into focus the breadth of governance activities that must be attended to by all boards. It is now more important than ever for nonprofit board members to demonstrate that the public’s confidence in nonprofit governance is justified.

In the hospital context, membership on nonprofit hospital boards brings with it the responsibility for board members to oversee the operations of the hospital they serve to safeguard its mission, values and assets. To discharge this responsibility, hospital board members must understand the complexities of the health care industry so that they can make informed and responsible decisions. The issues facing hospitals today are numerous and complicated. Hospital boards are faced with an increasing public focus on quality and safety, ever increasing financial pressures caused by declining reimbursement, presidential encouragement to provide the public with price transparency, a mandate to comply with numerous laws and billing requirements imposed by the government and third party payers, and deteriorating relationships between the hospital and its physicians as they both compete for the shrinking health care dollar. The challenge for hospital board members today is to understand and stay focused on discharging legal duties that have applied to nonprofit boards long before corporate scandals and SOX made national news. This monograph describes the board’s legal duties to make good decisions concerning the complex issues facing health care organizations today.

A Long History

Although most of the recent corporate governance reforms apply only to corporations trading shares on the New York Stock Exchange or NASDAQ, much has been written about the application of SOX to nonprofit boards. This is because SOX and the other corporate reforms applicable to publicly-traded corporations raise interesting issues for nonprofit boards to consider. Like for-profit boards, nonprofit boards are accountable to their stakeholders for the actions of the corporation. But, the stakeholders themselves are different for nonprofit boards than for their for-profit counterparts. Instead of shareholders, the stakeholders for nonprofit boards are state attorneys general, creditors, the local community, sponsoring religious orders, significant donors and others who have a stake in the organization’s activities and may have authority to take action under longstanding legal theories.

While SOX is undeniably important for nonprofit board members to understand and consider, there is concern that because of all the attention given to SOX, members of nonprofit hospital and health system boards may lose sight of their responsibility to the institutions they govern under other more fundamental and

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2 Guide to Nonprofit Corporate Governance in the Wake of Sarbanes-Oxley, ABA Coordinating Committee on Nonprofit Governance, (2005).
directly applicable legal duties. After all, when reduced to its essence, is SOX really novel? The basic principal of SOX is protecting the independence of governance decision-making, focusing on the best interest of the corporation itself and not on the self-interest of individuals. This is the same public policy that underlies the enactment of Internal Revenue Code provisions applicable to nonprofit health care, the Anti-Kickback Statute and the physician self-referral or Stark laws.

Certainly, the world of nonprofit health care has not been without its own problems. Consider, for example, the events occurring at Allina Health System, in 2001. Based on the view that Allina’s activities amounted to a “waste of corporate assets”, the Minnesota Attorney General overhauled the governance and management structure of the organization, forced a divestiture of one of Allina’s managed care affiliates and scrutinized the independence of the corporate auditors. In another case, the Florida Attorney General actively intervened to block a proposed plan to consolidate the services of Intercoastal Healthcare Systems, Inc. by taking steps to remove Intercoastal’s board of directors and impose a “constructive trust” on the organization’s assets. By imposing a “constructive trust” the Florida Attorney General was acting on behalf of the community by ensuring that any profits arising out of a consolidation or other corporate transaction such as a sale of the hospital, remain in the community. There, even though the board had engaged an outside advisor who determined that a consolidation of two separate hospitals was necessary for the continued financial viability of the system, the Attorney General effectively blocked the action by invoking powers to protect the assets of the organization as a “charitable trust” for the state. Creditors of a nonprofit organization (particularly an organization in financial distress) also have been successful in taking action against the organization based on allegations that its board and officers breached the trust put in them to safeguard corporate assets for the benefit of the corporation’s stakeholders, which include the organization’s creditors. In the highly public controversy surrounding the bankruptcy of Allegheny Health Education and Research Foundation (AHERF), millions were paid to unsecured creditors, among others, to settle charges that the board breached its fiduciary duties by using AHERF funds for the personal interests of AHERF’s Chief Executive Officer. Examples included political contributions, the rental and renovation of a stadium box in a sports facility, and a

new high school locker room, ultimately leading to the conclusion that the board had failed to adequately monitor what became a financial crisis for the system.4

As these few examples demonstrate, state attorneys general, creditor groups and others have become as active as shareholders of publicly traded corporations in challenging the actions of corporate boards. As a result, members of nonprofit health care boards are well-advised to understand their fundamental governance responsibilities. With a clear understanding of those responsibilities, nonprofit board members should be better prepared to grapple at the board level with existing and emerging issues facing the health care industry today.

Understanding the Corporation’s Purpose

Before assuming the responsibility to govern an organization, board members must understand the corporation’s purpose. Nonprofit health care organizations have a charitable purpose that focuses on preserving the health status of the community the hospital serves. Although the term “nonprofit” is not synonymous with “tax-exempt,” most nonprofit hospitals take advantage of the benefits conferred under § 501(c)(3) of the Internal Revenue Code and obtain tax exemption. To be exempt, under § 501(c)(3), the corporation must be organized and operated for a charitable purpose.5

In addition to the charitable purpose required to achieve tax exemption, charitable trust law in many states considers the assets of nonprofit organizations to be held “in trust” for the benefit of the communities they serve. Taken together, these laws require that the nonprofit corporation’s purpose focus on the interests of the community and not on the individual self-interest of any person or group.

All nonprofit corporation articles of incorporation or bylaws should state the organization’s corporate purpose. This statement of corporate purpose also is often reflected in corporate mission and/or vision statements developed or adopted by the board(s). To have a clear focus for all future decision-making, board members must know, understand and support the corporate purpose.

4 Attorney General Files Criminal Charges Against Three Former AHERF Officials, BNA Vol. 9, No. 12, (March 23, 2000).
5 See, 26 C.F.R. § 1:501(c)(3) (For a full discussion of the requirements that must be met to obtain 501(c)(3) status).
Boards Govern; Management Manages

Board members need to understand the role of the board in directing the activities of the organization and know the difference between governance and management. The board sets the strategic direction for the organization, appoints the Chief Executive Officer, oversees financial and operational performance and safeguards the assets of the organization. Management carries out day-to-day activities, implements the direction set by the board, and attends to the myriad details of running a modern health care organization. The board ensures that day-to-day activities are performed appropriately by appointing a qualified Chief Executive Officer and objectively monitoring his or her performance on an ongoing basis. Although the board is ultimately accountable for the actions taken by the organization’s officers and employees, actual involvement in governing the organization is usually limited to board or committee meetings or other more sporadic contact with the organization. Therefore, the challenge for all board members is to provide effective governance even though they are not present to oversee day-to-day activities.

Accountability

In a for-profit corporation, the directors’ constituencies are clear. Boards of for-profit organizations govern on behalf of shareholders, and the directors know that their primary obligation is to increase shareholder value. Shareholders are likely to hold the directors accountable, if the corporation fails to produce acceptable financial returns.

The constituencies of nonprofit organizations are not as easy to identify. The purpose of most nonprofit corporations is to provide a charitable benefit to members of the community, many of whom are incapable of holding the corporation and its board accountable to fulfill the organization’s purpose. Who, then, is in a position to call nonprofit corporate boards to account for their actions?

In many cases, nonprofit board members are held accountable by the state attorney general or other community representatives under a theory that the assets of nonprofit corporations are charitable assets that can be protected by the state or the community. In most states, the attorney general has the power to enforce the public’s interest by making sure that charitable organizations fulfill their charitable

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6 See e.g. Responsibilities of Directors and Officers of Not-for-Profit Corporations, Attorney General Eliot Spitzer, Charities Bureau. www.oag.state.ny.us/charities/charities.html.
purposes. Attorneys general typically exercise that power by making sure that charitable assets are preserved and are not diverted to a non-charitable purpose.

In addition to state attorneys general, other constituencies have the power to hold nonprofit boards accountable for their actions. Some nonprofit hospitals are organized into systems and have “members,” such as religious congregations, who hold certain rights or “reserved powers” over the actions of the corporation. These membership rights may allow the member to remove board members if they fail to act in the best interest of the corporation.

Constituencies of nonprofit corporations, particularly if they are financially distressed, also may include creditor groups. Once a corporation is in the “zone of insolvency” the corporation’s board should focus on protecting creditors.7

Health care providers also are regulated by a variety of federal, state and local government agencies that have significant enforcement tools at their disposal. Government investigations and enforcement actions are costly and embarrassing diversions of corporate resources.

Legal Duties of a Nonprofit Board Member

Individual board members are fiduciaries of the organization. As fiduciaries, board members must act at all times in the corporation’s best interest, ensuring that the organization’s resources are used in a reasonable, appropriate and legally accountable manner. Although the board does not generally get involved in the day-to-day operations of an organization, it remains responsible for overseeing management and making key strategic decisions. These decisions include authorizing major financial transactions, hiring and firing the organization’s senior officers and high-level employees and ensuring that the organization adheres to its mission and values.

Understanding the corporation’s purpose, the role of the board and the constituencies to whom the board is accountable is only the first step to effective governance. The board also must know and understand the core legal duties that guide all of its actions. For nonprofit boards, these duties are the highest imposed by law on any person or entity, the duties of a fiduciary, and include the Duty of Care, the Duty of Loyalty and the Duty of Obedience (see Figure 1: Nonprofit Healthcare Board Members’ Legal Duties).

FIGURE 1: Nonprofit Healthcare Board Members' Legal Duties

- Comply with Corporate Charter and the Law
- Honor the Corporate Mission
- Avoid Self Interest
- Avoid Conflicts
- Provide Appropriate Oversight
- Make Responsible Decisions

Duty of Care

Duty of Loyalty

Duty of Obedience

Members of Board
Legal Duties
Duty of Care – Making Responsible Decisions and Providing Appropriate Oversight

The Duty of Care requires board members to act in good faith and to use the same degree of diligence, care and skill that a prudent person would use in similar situations or circumstances. The Revised Model Nonprofit Corporation Act of 1987 (Model Act), upon which many state laws are patterned, articulates the Duty of Care imposed on officers and directors of a nonprofit corporation:

[a] director shall discharge his or her duties as a director, including his or her 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.8

While this legal principle has been known for many years, its application can be problematic. What does it mean? How do directors know if they are exercising appropriate “diligence, care and skill” as they grapple with real-life problems confronting the hospitals they serve? The answers are easier to see if the Duty of Care is reduced to its essential requirements.

Make informed decisions. The Duty of Care requires board members to make informed decisions, that is those that follow a reasonable effort by the board member to become familiar with the relevant, available facts. Boards should require management to provide complete information upon which to base an informed board decision. Then, individual board members must take the time to review the information prior to the board meeting. Boards are not required, however, to do their own independent investigation; and the law gives them leeway to rely on information given to them through reports received from management or the hospitals’ accountants, lawyers, and other advisors. For example, the Michigan Business Corporation Act states:

... a director or an officer, when acting in good faith, may rely upon the opinion of counsel for the corporation, upon the report of an independent appraiser, selected with reasonable care by the board, or upon financial

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statements of the corporation represented to the director or officer as corrected by the president or the officer of the corporation having charge of its books or accounts, or as stated in a written report by an independent public or certified public accountant or firm of accountants to fairly reflect the financial condition of the corporation.9

**Due inquiry.** Although the board is given latitude in discharging its first “due care” obligation to be informed, because the law permits the board to rely on information presented by management and its advisors, due care also imposes on boards the obligation to make due inquiry. This means directors are charged with asking questions if they learn facts that raise issues about the validity or completeness of the information presented to them. Due inquiry does not mean that the board must engage in independent fact-finding or otherwise go outside the boardroom to gather information. However, due inquiry mandates that board members dig deeper if they know of facts, learned inside or outside of the boardroom, that call into question the validity or completeness of the information presented by management.

**Business judgment rule.** In fulfilling a director’s Duty of Care, the courts of virtually every state further protect the actions of directors through the business judgment rule, which provides that a director will not be held personally liable if he or she makes an informed decision, in good faith, without self-interest, and in the best interests of the corporation. A 1996 case involving a multimillion dollar civil settlement and a criminal plea agreement by Caremark International, Inc. relating to alleged payment of kickbacks to physicians and improper billing of Medicare is considered by many as the leading case for application of the business judgment rule.10 In Caremark, the court found that the business judgment rule protects corporate directors from liability and that the court would not substitute its judgment for that of the directors unless the court found that the directors acted in bad faith or with gross negligence. The business judgment rule is focused on process rather than on the content of a board decision. The court held that even if in hindsight, it believed the board’s decision to be “substantively wrong,” insufficient grounds existed to find director liability if the board’s decision-making process was rational and followed in good faith.

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9 Michigan Compiled Statutes § 450.2101 et. seq.
Although the Caremark court upheld the application of the business judgment rule, the court also noted that at its core, the Duty of Care focuses on whether the board has made a good faith effort to be “informed and exercise judgment.” As evidence of good faith, the court stated that it was the board members’ duty to assure that an adequate corporate information and reporting system existed and that failure to do so may render individual board members liable for loss caused by non-compliance with the law. The Caremark decision has since been cited as establishing a legal obligation for health care boards to oversee development and implementation of effective corporate compliance programs.

Questions for Board Members

- Does the organization have sufficient internal financial controls and written policies to safeguard its assets and mission and is there a corporate compliance program to monitor these controls and policies?
- Do I know the significant risks to the organization?
- Do I have access to adequate information to make informed decisions?
- Does management provide the board with necessary materials prior to meetings and am I able to voice questions as they arise?
- Does the board participate in assessing organizational risk?
- Does the board participate in strategic planning discussions about the organization’s future?

Duty of Loyalty – Avoiding Conflicts of Interest or Self-Interest

The Duty of Loyalty requires board members to protect the corporation’s business interests and to refrain from deriving personal gain to the corporation’s detriment. This means that a director must act in good faith and without self-interest when making decisions for the corporation. The Duty of Loyalty includes a board’s obligation to avoid impermissible conflicts of interest, prevents board members from usurping a corporate opportunity for their own personal gain and requires board members to preserve the confidentiality of the corporation’s affairs.

While attention to conflicts of interest safeguards corporations from decisions guided by a board member’s self-interest, a board member is not automatically disqualified
from serving on a corporation’s board simply because he or she conducts business with the organization. Instead, the Duty of Loyalty and its prohibition against impermissible conflicts of interest, governs how the corporation and its members should act when a director’s business or personal dealings conflict with the interests of the corporation.

The Model Act provides that:

A conflict of interest transaction is a transaction with the corporation in which a director of the corporation has a direct or indirect interest. A conflict of interest transaction is not voidable or the basis of imposing liability on the director if the transaction was fair at the time it was entered into or is approved as provided [in 8.31].

Conflicts of interest are not rare and the Model Act, upon which many state statutes are patterned, permits organizations to conduct business with their board members so long as conditions are met to make sure that the organization’s interests prevail in the board’s decision-making. These conditions include: (1) giving the board advance notice that the item in conflict will be considered; (2) disclosing the identity of the director who possesses an interest in the transaction and the nature of that adverse interest; and (3) asking the interested board member to leave the meeting temporarily to allow the board to deliberate and vote on the transaction outside the presence of the interested director. By taking these actions, the board demonstrates its independence and assures that the transaction is fair to the organization. It is important for hospital boards to adopt a well-defined conflicts-of-interest policy and follow it when making critical board decisions or approving proposed transactions where a director or officer holds a conflicting interest. Further, there are specific rules applicable to certain transactions which, if followed, will create a rebuttable presumption that the organization and those involved in approving the transaction acted appropriately.

SOX introduced for for-profit corporations the concept of director independence and mandated certain procedures for boards to follow to preserve independence in

12 U.S. Dep’t. of Treasury, Instructions for Form 1023, Appendix A. (provides detailed information addressing the manner by which hospitals should both identify and address board conflicts of interest).
board decision making. This concept of board independence is not new to nonprofit governance. The requirement that boards be principally independent has long been required for those nonprofits that seek tax exemption under § 501(c)(3) of the Internal Revenue Code. The IRS has required for many years that boards of tax-exempt entities be composed of a majority of independent, community representatives as a protection against board decision making that may be tainted by private interest. By taking steps to preserve board independence, such as allowing time for the board to meet with the hospital’s independent auditors or discuss issues in executive session without the influence of management, the board further avoids impermissible conflicts of interest and meets the Duty of Loyalty to the organization.

In addition to conflicts of interest, the Duty of Loyalty also includes the doctrine of corporate opportunity, which means that a director may not take advantage of a business or financial opportunity that reasonably would be of interest to the corporation. If the opportunity could possibly fall within the corporation’s current or future plans or activities, the opportunity must first be offered to the corporation. When a board member engages in self-dealing by diverting a corporate opportunity to him or herself or to a competing organization, the board member breaches a fiduciary duty to the corporation.14 An officer or director who assists a competing entity may be found to have breached his or her Duty of Loyalty to the organization.15

Questions for Board Members

• Does the hospital have a policy on conflicts of interest?
• Do I understand how conflicts are addressed?
• Does the board meet with the organization’s auditors without the CEO present?
• Does the board meet in executive session without the CEO present?
• Does the hospital have a policy on corporate opportunity?


Duty of Obedience

The Duty of Obedience calls on the board and its members to comply with the requirements of applicable laws, rules and regulations, honor the terms and conditions of the organization’s mission, bylaws, policies and procedures, and act at all times within the scope of their authority under the corporation’s articles, bylaws and applicable laws. The adequacy of board member efforts to meet the Duty of Care is tested in pursuing the Duty of Obedience.

The responsibility of nonprofit board members to adhere to the Duty of Obedience far exceeds that of their for-profit counterparts, where the principal purpose of the organization is to produce financial returns for shareholders. In the nonprofit arena, the corporate purpose requires the board to do more than focus on the financial health of the organization. The corporate purpose in the nonprofit context requires boards to safeguard the organization’s charitable purpose and preserve the hospital’s assets held in trust for the community. Nonprofit corporate board members have a duty to abide by applicable statutes and the organization’s articles, bylaws and mission/vision statements in performing their corporate duties and responsibilities.

Directors of nonprofit organizations also have a duty to act within the scope of their authority as defined by law and by the articles and bylaws of the organization. If a director takes action outside of that authority, he or she may be charged with committing an “ultra vires” act, or an act beyond the power allowed by corporate charter. Such action may incur liability to the corporation for damages caused by the director’s unauthorized act.

For hospital board members, the Duty of Obedience can be paramount to all other duties. Even well-thought out decisions can be challenged if they are not faithful to the purpose of the organization. The board of Manhattan Eye, Ear & Throat Hospital (MEETH) in New York learned this lesson first-hand when in 1999 New York Attorney General Eliot Spitzer blocked its plan to sell the real estate assets of the 130-year-old nonprofit hospital. Although the board believed it was responding appropriately to the financial decline of the hospital with a carefully developed plan, supported by retained advisors, to develop outpatient centers to serve the
poor, Spitzer attacked the board’s decision because it failed to preserve MEETH’s corporate purpose as a hospital, as stated in its articles of incorporation. At least in this case, the board’s actions in support of its Duty of Care was trumped by its obligations under the Duty of Obedience.

**Applying These Legal Duties to Nonprofit Governance**

*Continuing Oversight of Legal and Regulatory Compliance.* Nonprofit hospitals and health systems operate in a heavily regulated environment calling for continuous compliance with requirements imposed by federal, state and local law and regulation. Over the last decade, most organizations have implemented corporate compliance programs to reduce the risks of noncompliance with the voluminous and often confusing laws governing health care today, including the complex reimbursement and coverage rules of the Medicare and Medicaid programs. Failure to comply with the laws applicable to government payment programs can lead to significant civil or criminal penalties, recoupment of improper payments or even suspension or termination from Medicare or Medicaid—financial death for any hospital. Not only is non-compliance embarrassing to hospital leadership, but significant time and resources, which should otherwise be spent on the delivery of care, are diverted. Various governmental agencies with enforcement authority and private whistleblowers are aggressively investigating and enforcing the law, and there is no indication that enforcement activity is likely to relax in the foreseeable future. Accordingly, board members must be confident that an effective compliance plan is in place to assist the board in meeting the Duty of Care.

In addition to being an important oversight tool, effective compliance plans can have real legal benefit to the corporation. When calculating a “culpability” score, the Federal Sentencing Commission Guidelines, under which criminal sentences can be imposed on corporations, give credit to organizations that have an “effective corporate compliance program” in place (see box on page 17). The credit given to organizations for having an effective compliance program can result in a smaller corporate fine.


Similarly, the Office of the Inspector General of the Department of Health & Human Services (OIG) has encouraged the operation of effective compliance programs. The OIG has stated that among the factors it will consider when imposing penalties resulting from disclosure of non-compliance with applicable rules are “the severity and extent of the underlying misconduct, the nature and resources of the provider, the provider’s existing compliance capabilities, and whether the case resulted from a self-disclosure.”

While compliance plans primarily focus on preventing fraud and abuse in federal and state health programs, other legal risks can arise from operating a nonprofit hospital or health system for which the board has oversight responsibility. Certain parts of the overall compliance effort may be executed in other committees or programs in the hospital and not specifically delegated to the corporate compliance program. Legal compliance occurs in places such as a board audit committee, compensation committee or executive committee. For example, the Internal Revenue Service (IRS) imposes numerous requirements that must be met to protect a hospital’s tax-exempt status. A hospital can either lose its exemption, or be subject to significant excise taxes, if it fails to comply with these requirements. The board

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can delegate matters of concern to the IRS to its audit committee or compensation committee. Nonprofit board members must know where such issues are reviewed and receive an appropriate level of reporting about them.

Nonprofit health care board members must be aware of the legal, regulatory and accreditation standards for which they have oversight responsibility. New issues are always emerging and old issues evolving. For example:

- The Federal Trade Commission has been very active in challenging anti-competitive behavior under applicable antitrust laws. The Commission has focused recently on contracting activities which may constitute illegal price fixing or boycotts. Mergers, acquisitions, or joint ventures with competitors also are a continuing area of intense scrutiny.

- How hospital or health systems address the privacy of personal health information is another issue of great concern, with penalties for non-compliant organizations.

- Most hospitals and health systems also voluntarily seek to meet the rigorous standards of non-governmental accreditation entities, most notably the Joint Commission on Accreditation of Healthcare Organizations (JCAHO). Loss of accreditation can disqualify an organization from participation in Medicare and Medicaid. Both JCAHO and Medicare impose specific responsibilities that must be carried out by the hospital board, such as overseeing the organized medical staff, approving the hospital’s operating and capital budgets, overseeing the management of patient complaints, and others.

- Intense scrutiny is currently focused on billing and collection policies for the uninsured and the amount of charity care provided by the organization. Failure to satisfy appropriate tax authorities can result in sanctions as severe as loss of property tax exemption, as recently affirmed against Provena Covenant Medical Center by the Illinois Department of Revenue.\(^{19}\)

### Questions for Board Members

- Do I know which government agencies regulate our activities?
- Am I informed of newly emerging legal trends that affect our hospital?
- Am I advised of any legal investigations or legal risk exposure to the corporation?
- How often do I receive a report on legal risks?

\(^{19}\) *Dep’t. of Rev. v. Provena Covenant Med. Ctr.*, Ill. Dept. of Rev. PT 06–26(2006).
To properly discharge the Duty of Care, mere knowledge that the organization has a compliance program is not enough for nonprofit board members. Is the corporate compliance plan a book gathering dust on a shelf or is it integrated into the daily operations of the hospital or health system? Are certain legal risks addressed by the organization outside of the compliance program? Are board members adequately advised of significant risks and management’s response? Unless board members can answer the following questions and those that logically follow, they should not rely on the compliance plan as an effective oversight tool.

Questions for Board Members

- What is the structure of the compliance program?
- How does the compliance program work? Are there legal compliance issues affecting the corporation that the corporate compliance plan does not monitor or address?
- Has the corporation implemented a reporting system for the compliance plan? How often do members of the board receive reports about compliance issues?
- Who decides which risks will be monitored by the compliance program?
- Does the board provide input about which risks should be monitored? Is the board sufficiently informed to give meaningful input?
- Does the compliance officer meet directly with the board?
- Are there mechanisms in place to evaluate compliance plan effectiveness? Who is responsible for evaluating the plan? How often is the plan evaluated? Do meaningful changes occur as a result of the evaluation?
- Are remedial measures taken when problems are identified? Are those measures monitored?
- What is the policy for reporting compliance issues?

Upholding the National Mandate to Improve Safety and Quality. Patient safety and quality has risen to the forefront of national issues facing health care organizations today, spurring change in how quality is addressed. Years ago, quality activities in hospitals were based on individual cases. Hospitals attempted to improve quality by responding and reacting to individual incidents. Today, however, quality in hospitals is a scientific process of measuring and reporting on a variety of data to guide
performance improvement. The modern trend is to standardize clinical practice in hospitals according to “best practice,” evidence-based medicine. Hospitals now are required by both the Centers for Medicare and Medicaid Services (CMS) and the JCAHO to monitor and report on their compliance with these standardized practices, (called core measures) and other quality standards.

The Duty of Care requires that boards be aware of the growing national trend to improve quality and safety in health care. They also must be familiar with how hospitals and health systems are responding to the increasingly public focus on quality. The OIG, which has authority to exclude hospitals from participation in Medicare and Medicaid programs for substandard care, has stated that most hospitals should “continually measure their performance against comprehensive standards” including those of federal and state government and accreditation organizations.20

Questions for Board Members

• Do I know and understand the hospital’s strategy for improving quality and safety?
• Do I understand our quality data? Does the board receive reports on the hospital’s compliance with quality standards?
• Do I understand the trends and am I sufficiently informed to determine whether the hospital’s performance in meeting quality targets improves over time? If performance is not improving, do I know what the board is doing to spur improvement?

Physician Relationships and Competition. The relationship between hospitals and their medical staffs has changed over time. It is not unusual, in many markets, for physicians to compete directly with hospitals by owning specialty hospitals, ambulatory surgery centers, imaging centers, laboratories, and other facilities. What happens if a physician who holds such a competing interest also sits on the hospital board? Can a physician-director who also owns a competing business adequately discharge the Duty of Loyalty to the hospital?

There is considerable question about whether a board member can discharge adequately the Duty of Loyalty if he or she owns or holds an ownership or management relationship at a competing business. While not the subject of this monograph, it must be noted that other issues must be addressed if the board concludes that a physician board member cannot meet the Duty of Loyalty. Removing a physician board member from the board and medical staff may violate the physicians’ rights under the Medical Staff Bylaws and in some states, the restrictions on economic credentialing. Boards must analyze carefully whether the competing physician board member can discharge his or her Duty of Loyalty to the hospital and if not, the consequences of remedial action.

**Questions for Board Members**

- Can a director act fairly for the hospital when he or she holds a competing interest?
- Is the competing interest limited so that the board member can simply be recused when issues affecting that interest arise? Or, is the competing interest so pervasive that it cannot be isolated to single issues?
- Is a director taking advantage of an opportunity that belongs to the corporation?
- Will the director have the potential to profit personally to the hospital’s detriment?

_Safeguarding Charitable Assets_. Nonprofit board members need to be aware that Congress is focusing on the charitable nature of hospitals today. The rewards of tax exemption are at risk if hospitals fail to justify their charitable focus through how they render care to the communities they serve. In undertaking these responsibilities, board members should understand where liability can arise and know the available legal protections, so that the board can address these emerging issues in a way that minimizes both personal and organizational risk.

In recent years, Congress, lead by Senator Charles Grassley, has launched an intense investigation of tax-exempt organizations, particularly hospitals, and the extent to which they justify tax exemption by fulfilling their charitable purpose. This investigation has probed hospital policies on charging the uninsured for care, quantified the amount of charity care and community benefits provided by
tax-exempt hospitals, and explored executive compensation and other benefits provided by tax-exempt hospitals to those in a position to reap financial reward at the expense of the corporation.

For many years the IRS has been concerned about compensation of highly placed executives. In 1996, Congress authorized the IRS to impose excise taxes on those who benefit from what the law defines as “excess benefit transactions”, as well as those who participate in approving such transactions. The same legislation also created a “rebuttable presumption of reasonableness” which shields the parties to excess benefit transactions from excise taxes if they follow certain procedures. Nonprofit board members should understand how the organization reviews and awards compensation or other remuneration to “disqualified individuals” and be assured that the criteria for applying the rebuttable presumption of reasonableness are being met.

Questions for Board Members

- Which board committee reviews transactions with disqualified individuals?
- What are the review procedures and will our organization qualify for the rebuttable presumptions?
- How many transactions are processed in this way?
- What reports does the board receive from the committee that reviews and approves these transactions?

Protecting the Credit Rating of the Hospital. Many nonprofit hospitals and health systems rely on the tax-exempt bond market to raise funds for capital improvements and investment. Bonds are more attractive to the non-profit organization as a funding source if they can be obtained at reasonable rates, because a heavy debt service burden can be a long-term impediment to the organization’s success. Rates for exempt bonds depend on ratings from major ratings entities. As discussion heated


22 A “disqualified individual” is defined as “... any person who was ... in a position to exercise substantial influence over the affairs of the organization.” 26 U.S.C. § 4958(f)(i).
up about corporate governance after SOX was enacted, Standard & Poor’s, Moody’s, and Fitch weighed in on the importance of good governance as a factor in their ratings methodologies. When a favorable assessment of governance can make the difference on a close call between two ratings, the board’s performance contributes to generating more funds at a better rate. Therefore, board performance, in the eyes of these important credit assessment entities, will directly affect the board’s ability to fulfill the nonprofit hospital’s corporate purpose and mission/mission. Moody’s\textsuperscript{23} considers the following governance factors in its ratings assessments:

- Development of the organization’s mission
- Selection and evaluation of senior management
- Board composition and performance
- Understanding and interpretation of financial reporting
- Use of performance metrics based on external benchmarks to regularly review an institution’s performance
- Maintaining and building the organization’s financial resources
- Avoiding conflicts of interest

**The Buck Stops with the Board**

Nonprofit hospital boards today have an important and challenging job. It can be performed properly only if board members understand their role and the legal duties that guide their actions. By creating and maintaining an independent, empowered and knowledgeable board fully aware of how to effectively govern a charitable organization, nonprofit hospitals can be assured that governance is properly conducted and adds value to the hospital now and into the future.

\textsuperscript{23} Special Comment, Moody’s Investors Service, June, 2005.
Recommended Readings


- **Volunteer Board Member of Illinois Not-for-Profit Organizations**, Illinois Attorney General. Available at: http://www.ag.state.il.us/charities/volunteers.html.


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