American Association of Homes and Services for the Aging

Conflicts of Interest for Trustees, Directors, and Management in the New World of Integrated Services and Collaborative Ventures

A Primer on Conflicts

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Table Of Contents

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I. INTRODUCTION

A. **<u>Increasing Importance of Conflicts of Interest and Confidentiality</u>**. Today's complex healthcare marketplace of joint ventures, affiliations, mergers, and network development has heightened the importance of conflicts of interest for several reasons.

1. Conflicts of interest, including strains between the obligations an individual owes to different organizations, are more common.

    a. Individuals in the healthcare arena often wear many hats. For example, a trustee[1] of one organization may be asked by that organization to serve on a network board.

    b. As other examples, an employee of an organization might have a spouse who owns a related business in the healthcare field, or a trustee may be asked to serve on the board of a related corporation controlled by the same integrated system.

2. Regulatory agencies are vigilant about perceived improper conduct of directors and employees of healthcare organizations.

    a. For example, the Internal Revenue Service (the "IRS") is focusing on insider transactions with organizations exempt under section 501(c)(3) of the Internal Revenue Code (the "Code").

        - The IRS has published a sample conflicts of interest policy (the "IRS Model Policy") and has suggested that the existence of a comprehensive policy is a factor the IRS will consider in evaluating some issues. IRS EXEMPT ORGANIZATIONS DIVISION, CONTINUING PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM TEXTBOOK FOR FISCAL YEAR 2000, 48 (1999) (hereinafter "2000 IRS TEXTBOOK").

    b. Congress is increasingly trying to stop the self-interested transactions of healthcare providers through legislation such as the Medicare/Medicaid anti-kickback prohibition, the Stark Act, and "Intermediate Sanctions."

3. The public is increasingly sensitive to conflicts issues and the appearance of self-dealing, particularly in charitable organizations. The public expects these organizations to be motivated by purely altruistic motives.

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[1] Note: The terms "trustee" and "director" are used interchangeably throughout this Primer to refer to individual members of the governing board of a nonprofit organization.

4. Organizations unhappy with business arrangements they made may assert conflicts of interest to try to undo the arrangements. For example, Grossment Health Care District in California is now attempting to undo a 30-year lease that it executed in 1991 and is alleging that its executives, board, and attorney had conflicts of interest.

5. The growing intolerance exposes organizations, trustees, and employees to potential liabilities and penalties.

    - An example is the federal Intermediate Sanctions legislation imposing penalty excise taxes personally on insiders who engage in improper transactions with a tax-exempt organization.

6. Compliance with conflict of interest policies is essential to insuring entitlement to available protection from liability.

    a. State statutes offering directors protection against liability, including liability to the Corporation, generally include some variation of a standard that makes the protection only available if the director acted in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and in a manner he reasonably believes to be in the best interest of the corporation. If a director (or an associate) receives an improper personal economic gain or if directors negligently approve an improper transaction with an insider without having and enforcing an effective conflicts policy, the directors likely will not be protected from personal liability.

    b. Coverage requirements in a typical Directors & Officer insurance ("D&O") policy require directors and officers to meet similar standards of conduct and care to be entitled to be defended and covered by the insurer.

    c. Directors, officers and top management will receive some protection from the imposition of IRS Intermediate Sanctions if, in the case of an insider transaction or financial arrangement, the conflict is identified in advance of board approval and certain requirements, including outside independent confirmation of the fairness of the value, are met.

    d. Although the Federal Volunteer Protection Act of 1997 offers some liability protection to volunteers, the statute will probably not afford protection to a director defending a claim related to conflict of interest because the Act does not apply to a claim for damages brought by or on behalf of the organization.

B. **Scope of the Term "Conflict of Interest**." Although the term "conflict of interest" has a narrow technical meaning, the term commonly describes a number of situations in which an individual has conflicting loyalties or interests.

1. The term "conflict of interest" technically refers to a situation in which a director has a material personal interest in a proposed contract or transaction to which the corporation may be a party.

    a. The personal interest may be that of the individual director or of a close family member.

    b. The material personal interest is generally a financial interest, although a conflict of interest can arise even if the director or family member receives no monetary or other tangible benefits from the contract or transaction in question.

2. The term "conflict of interest" is now used also to address situations in which a director or employee has fiduciary or other obligations to more than one organization and those obligations conflict.

    a. These conflicts generally arise when an individual has a duty of loyalty to two organizations, a matter arises at one organization that could affect the interests of the second, and the decision of the first organization would either hurt or help the other. The director cannot participate in the decision at the first organization because of his or her duties to the second.

    b. A frequent solution to this dilemma is non-participation by the director in any actions or matters for either organization that might affect the other.

    c. If the conflicts between the duties to the two organizations are frequent and intense, the solution may be for the director or employee to resign from one organization.

3. For purposes of this Primer, traditional conflicts of interest as well as tensions caused by conflicting loyalties to organizations are addressed, and except in those cases in which a pure "conflict of interest" is addressed, the term will be used broadly.

C. **Organizational Management of Conflicts of Interest.** The existence of a conflict of interest is not inherently illegal or improper, and the existence of a conflict does not reflect on the integrity of the individual with the conflict. AMERICAN BAR ASSOCIATION GUIDEBOOK FOR DIRECTORS OF NONPROFIT CORPORATIONS 28 (*George W. Overton ed.*, 1993) (hereinafter "ABA GUIDEBOOK").

1. Conflicts are inherent, for example, in trade association boards or network boards.

2. In many cases, the strengths that an individual director brings to the board flow from other interests or experience that the director may have.

3. The issue is how conflicts of interest are in fact identified and managed.

4. The development by a board of effective mechanisms and policies to identify and manage conflicts is critical. Annual disclosure, annual board orientation, and periodic monitoring of disclosures contribute to effective management.

II. SOURCES OF STANDARDS OF BEHAVIOR AND OBLIGATIONS

A. **General.** Conflicts of interest generally arise when an individual, whether a trustee or an employee, has defined duties or obligations to one organization as well as other duties or personal interests. Familiarity with the sources of duties is therefore essential to the ability to identify and manage conflicts.

B. **Common Law.**

1. **Duty of Loyalty.** Directors and officers must exercise their powers in the best interests of the corporation, not in their own interests or the interests of another person or organization.

   a. Directors and officers may not use a corporate position for individual personal advantage or take an opportunity available to the corporation and use it personally.

      i. Corporate Opportunity Doctrine: a director breaches his or her duty when the corporation has a prior claim to a business opportunity and the director usurps (takes) that opportunity.

      ii. Joint ventures "pose the potential for new types of conflicts ..., especially with respect to corporate opportunities that may arise in the future. To avoid or minimize dispute, it is often helpful to spell out rights of first refusal and other understandings up front in the definitive agreements." *Gerald M. Griffith, Changing Fiduciary Duties in the Nonprofit Sector*, 5 BNA HEALTH LAW REPORTER 1759, 1761 (Dec. 5, 1996), citing *S. Glover, Joint Ventures and Opportunity Doctrine Problems*, 9 INSIGHTS 9 (Nov. 1995).

   b. Confidentiality concerns arise primarily under the duty of loyalty.

      i. Directors and officers have access to confidential information about corporate affairs, including potential mergers, acquisitions and affiliations.

ii. A director or officer "should not, in the regular course of business, disclose information about the corporation's legitimate activities unless they are already known by the public or are a matter of public record." ABA GUIDEBOOK at 32.

iii. Directors and officers are obligated to use reasonable diligence to "protect and safeguard" corporate information. WILLIAM E. KNEPPER AND DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS, 4-23, p. 165 (6th ed. 1998).

iv. A director or officer may have private information about one company that is crucial to another organization of which he or she is also a director. The director generally may not reveal the information, participate in action at the second organization, or disclose the basis of his or her conflict without breaching his or her duty to the first.

v. An organization should consider adoption of a policy about confidentiality.

c. A director may have competing obligations to two or more organizations and may not be able to act on certain matters without breaching his or her duty to one or both corporations.

d. The duty of loyalty "requires that a director be conscious of the potential for [conflicts of interest] and act with candor and care in dealing with such situations." ABA GUIDEBOOK, *supra* at 28.

e. Conflicts of interest primarily involve the duty of loyalty, but the duties of care and obedience are also implicated.

2. **Duty of Care.**

a. Trustees and officers have a duty to participate in the decisions of the board and be informed about data and information relevant to such decisions. ABA GUIDEBOOK, *supra* at 21.

b. Stated another way, trustees and officers must be (1) reasonably informed, (2) participate in decisions, and (3) do so in good faith and with the care of a prudent person in similar circumstances. ABA GUIDEBOOK, *supra* at 21.

i. "The good faith requirement has been interpreted by the courts to mean the exercise of the duties of a director or officer consistent with the duty of loyalty to the corporation, i.e., without unjust enrichment, bad faith or fraud." *Griffith*, *supra* at 1760.

ii. Generally, if a director has met this standard, under what is commonly referred to as the "business judgement rule," a court will not substitute its judgment for the judgment of a director in the operation of the corporation. *Griffith, supra* at 1760.

3. **Duty of Obedience**. Directors and officers are required to act within the bounds of the law generally, and with the intent of achieving the organization's "mission," as expressed in its charter and bylaws.

C. State Statutes. Each state has statutes relevant to the duties of a trustee and director, as well as statutes defining traditional conflicts of interest. Although the statutory provisions are generally very similar from state to state, each organization should carefully review the relevant statutes of its state to ensure that its policies are consistent with those statutes.

1. **Standard of Care.** State statutes defining the standard of care expected of directors generally restate the basic common law duties reviewed earlier.

a. **Model Act.** Many states have adopted the Revised Model Non-profit Corporation Act (the "Model Act"). Section 8.30 of the Model Act provides that directors are required to:

i. Discharge their duties as a director in good faith; and

ii. With the care an ordinarily prudent person in a like position would exercise in similar circumstances; and

iii. In a manner the director reasonably believes to be in the best interests of the corporation.

b. The equivalent California statute is slightly different. Section 5231 of the Cal. Corp. Code (West Group 2000) provides that a director shall perform the duties of a director:

i. In good faith; and

ii. In a manner such director believes to be in the best interests of the corporation; and

iii. With such care, including reasonable inquiry, as an ordinarily prudent person in a like position under similar circumstances.

c. Delaware's statute is somewhat unusual because the state does not have a nonprofit corporation act, and its general corporation law applies to both for-profit and nonprofit corporations.

i. More unusually, the Delaware corporation law has no statement of the general standard of care required for directors. The reference to good faith is in Section 141(e) of the Delaware Code, which states that any director's good faith reliance on the records of the corporation or information, opinions, reports or statements presented by any of the officers or employees is fully protected. This implies that good faith is recommended, but it is not explicitly required.

ii. Despite the lack of statutory guidance, Delaware courts have expounded on the fiduciary duties of a director.

2. **Conflicts of Interest.** State corporation laws also generally provide that, when a director has a significant personal interest in a transaction or decision of a corporation, the director should not participate in the vote. These statutes also generally outline the procedures the corporation may use to obtain effective action on the transaction even though a director has a conflict. These statutes govern, of course, the traditional "conflict of interest."

a. Model Act. Under Section 8.31, a "conflict of interest transaction" or "conflicting interest transaction" is a transaction with the corporation in which a director of the corporation has a direct or indirect interest.

i. Conflicting interest transactions are not voidable under the Model Act if:

- The transaction was fair at the time it was entered into; or
- If it involved a public benefit or a religious corporation,
  - it was approved in advance by a vote of the board (or a committee of the board);
  - the material facts of the transaction and the director's interests were disclosed; and
  - the directors approving the transaction in good faith reasonably believed that the transaction was fair to the corporation.

ii. Not every interest of a director will be material. An interest is material if there is a substantial likelihood that a reasonable person would consider it important in deciding what action to take.

b. Florida. Statutory provisions cover conflicting interest transactions between,

i. A corporation and one or more of its directors,

ii. A corporation and another corporation in which one or more of its directors are directors or officers; and

iii. A corporation and any other corporation, firm, association, or entity in which one or more of its directors are financially interested.

Such transactions are not voidable if:

i. The facts of such relationship are disclosed to the board of directors or committee of the board, and such board or committee approves, authorizes or ratifies the transaction by a vote of more than one disinterested director, not counting the vote of the interested director; or

ii. The fact of the relationship is disclosed to the members entitled to vote and they approve, authorize or ratify the transaction by a vote or written consent; or

iii. The contract or transaction is fair and reasonable as to the corporation at the time it is authorized by the board, a committee, or the members.

(See Section 617.0832 of the Florida Statutes (West Group 2000)).

c. New York. The relevant statute provides:

i. A contract or transaction between a corporation and one or more of its directors, or between a corporation and any other corporation, firm, association or other entity in which one or more of its directors or officers are directors or officers, or

ii. Between a corporation and any other corporation, firm, association or other entity in which one or more of its directors or officers have a substantial financial interest,

Shall not be void or voidable if one of three things occurs:

i. Disclosure to the board or committee and authorization by such board or committee by a sufficient vote, not counting the vote of the interested director or officer; or

ii. Disclosure to the members and good faith authorization of the contract by a vote of such members; or

iii. If there was no disclosure or knowledge, or if the vote of such interested director or officer was necessary for the authorization of such transaction, the contract still may not be voided if the parties establish affirmatively that the contract or transaction was fair and reasonable as to the corporation at the time it was authorized.

(See Section 715 of McKinney's New York Not-for-Profit Corporation Law (West Group 2000)).

d. California. The California Nonprofit Corporation Law imposes a high standard of proof in order to establish the legitimacy of an interested transaction involving a public benefit corporation. In order to uphold a transaction between a public benefit corporation and an entity with which one of its trustees is affiliated, the nonprofit must establish the following:

i. the transaction was for the nonprofit's own benefit;

ii. it was fair and reasonable to the nonprofit at the time;

iii. it was authorized by a majority of the trustees then in office, without counting the vote of the interested trustee(s), with knowledge of the material facts and the trustee(s)' interest; and

iv. it was authorized after reasonable investigation that it was the most advantageous arrangement that could have been attained at the time through reasonable efforts.

(See California Corporate Code §5233 (West Group 2000))

e. The wide variation in these statutes dictates that each board must become familiar with its own statute.

f. Knowledge of these statutes is critical to effective management and decision making in conflict situations.

3. Miscellaneous. A state may have other statutes relevant to particular decisions or corporations. For example, the Uniform Management of Institutional Funds Act,

adopted by many states, contains a standard for required board behavior with respect to charitable funds.

D. Relevant Provisions of the Internal Revenue Code.

1. Inurement and Private Benefit. The basic exemption language in section 501(c)(3) of the Code explicitly provides that a corporation, trust, or association may qualify for exemption only if, among other things, "no part of its net earnings inures to the benefit" of any private individual. This proscription is generally viewed as having two components.

    a. "Inurement" occurs when an insider (e.g., a trustee, a top manager, or a major donor) gets a benefit or something of value from the organization and does not give fair value in return. The insider must have the ability to substantially influence the organization.

    b. "Private benefit" occurs when an individual (not an insider) receives more than an incidental benefit from a transaction or arrangement with the organization and the individual has not given fair market value for that transaction or benefit.

2. Intermediate Sanctions. Prior to the Taxpayer Bill of Rights 2, the IRS's only weapon against inurement was revocation of an organization's exemption. This was rarely used by the IRS for obvious reasons. Effective for transactions occurring on or after September 15, 1995, however, the IRS may assess "intermediate sanctions", or federal penalty excise taxes, on individuals who receive, or approve transactions conferring, private inurement.

    a. Thus, instead of penalizing the organization, intermediate sanctions impose personal excise tax liability on the individuals who actually receive excessively rich economic benefits from a tax-exempt organization or who approve such benefits.

    b. The sanctions will apply in cases of excessive compensation or other transactions in which an insider receives an economic value greater than the value provided. Covered transactions could include:

        i. A sale of assets,

        ii. Loans on other than commercially reasonable rates and terms, or

        iii. Leases of property or equipment.

    c. The excise tax is applied to the "excess benefit," or the amount in excess of the actual fair market value of the transaction or service. For example, if an

asset worth $100,000 was sold to an insider for $75,000, the "excess benefit" is $25,000.

i. For the insider, or "disqualified person," who receives the excess benefit, the initial tax is 25% of the excess benefit. If the excess benefit is not corrected/paid back in a certain period, the insider is subject to an additional tax of 200% of the excess benefit. For example, if the excess benefit was $25,000, the potential excise tax on the insider is $56,250 ($6,250 + $50,000).

ii. An "organization manager" who approves or knowingly participates in approval of the transaction or arrangement in question is subject to a 10% excise tax. Thus, if the excess benefit is $25,000, the organization manager is responsible for a $2,500 excise tax. This liability is shared jointly among all organization managers who knowingly participate.

d. **Disqualified Person.** The statutory term for an insider is "disqualified person" or "DP", which is defined broadly to include:

i. Any person who

- at any time in the five years before the transaction
- was in a position to exercise substantial influence over the affairs of the organization,

ii. A member of the family of such a person, or

iii. An entity (corporation, partnership, trust, etc.) in which such a person (or family member) controls 35%.

e. **Facts and Circumstance Test.** Proposed regulations offer some further guidance on who is a disqualified person. These proposed regulations apply a "facts and circumstances" test to determine status. Factors tending to show a person has substantial influence and should be considered a disqualified person include:

i. the person is a founder of the organization;

ii. the person receives compensation based on revenues from activities that the person controls;

iii. the person has authority to control or determine a significant portion of the organization's capital expenditures, operating budget, or compensation for employees; or

iv. the person owns a controlling interest in an entity that is a disqualified person.

Facts and circumstances tending to show that a person does not have substantial influence include:

i. the person has taken a vow of poverty as an employee or agent of a religious organization; and

ii. the person is an independent contractor, such as an attorney or accountant, without a potential economic interest in the transaction being questioned (aside from the receipt of fees for professional services).

Proposed Treas. Reg. §53.4958-3(e).

f. The Committee Report accompanying the Taxpayer Bill of Rights 2 discusses a procedure that an organization may use to create a "rebuttal presumption" that a transaction or compensation arrangement was reasonable. The arrangement must be approved in advance by a board or a board committee:

i. Composed of disinterested individuals,

ii. Utilizing objective and appropriate data on comparability,

iii With adequate documentation of the basis for the determination.

g. The IRS proposed regulations offering additional guidance on the scope and applicability of the Intermediate Sanctions were published in July 1998 but are still not final.

h. The IRS imposed Intermediate Sanctions on director-owners and organization managers of a number of related home health agencies in Mississippi arising out of the conversion of the agencies to for-profit entities owned by the director-owners; the U.S. Tax Court is currently considering ten cases challenging the imposition of the Sanctions. Sta-Home Health Agency of Jackson, Inc. v. Comm'r, Docket No. 17342-99 and related petitions.

E. Clayton Act, Section 8.

1. In certain situations, federal law flatly prohibits a director's membership on the board of a competing institution even if it is disclosed and approved by both organizations.

2. **Section 8** of the Clayton Act provides that no person shall, at the same time, serve as a director or officer in any two corporations (other than banks) that

   a. are engaged in commerce and

   b. are competitors,

   c. if each has a net fund balance over $16,732,000,

   d. except that simultaneous service as a director or officer in any two corporations is not prohibited if the competitive sales of at least one corporation are less than $1,673,200.

3. The $16,732,000 and $1,673,200 thresholds were effective January 24, 2000 and are adjusted annually.

4. The impetus for this provision is not grounded in fiduciary concerns. Instead, Congress was interested in preventing collusion that is likely to lessen competition.

5. An "indirect interlock" may arise if different individuals who sit on the boards of competitors are actually serving as representatives of a single person or corporation. The Department of Justice has taken the position that corporations are "persons" and may violate the statute if they have representatives serving on the boards of two competing corporations. AMERICAN BAR ASSOCIATION, ANTITRUST LAW DEVELOPMENTS (THIRD) 397, n.749 (Williard K. Tom et. al, eds 1992).

F. Miscellaneous.

1. **JCAHO**. The 1998-99 edition of the JCAHO Comprehensive Accreditation Manual for Long Term Care requires that the long term care organization describe what constitutes a conflict of interest, and develop guidelines for disclosing existing or potential conflicts of interest. RI 4.2, p. 172.

   a. Long term care organizations should practice ethical behavior involving the relationship of the organization and its staff with other health care providers, educational institutions and payers. RI 4.2, p. 172.

   b. In addition, RI 4.2 requires that long term care organizations should:

      i. interview organization leaders regarding potential conflicts; and

ii. develop a board conflicts of interest policy.

2. **Medicare and Medicaid.**

a. The Medicare and Medicaid regulations require providers to submit, within 35 days after a written request, full and complete information about:

i. The ownership of any subcontractor with which the provider has had business transactions totaling more than $25,000 during the preceding 12-month period;

ii. Any "significant business" transactions between the provider and any wholly owned supplier, or between the provider and any subcontractor, during the five year period ending on the date of the request.

42 C.F.R. 420.205(a) and (b); 42 C.F.R. 455.105(b).

iii. A "significant business transaction" exceeds the lesser of $25,000 or 5% of a provider's total operating expenses. 42 C.F.R. 420.201 and 455.101.

b. The Medicare regulations also require disclosure of:

i. The identity of any other entities to which payment may be made by Medicare, which a person with an ownership or control interest or a managing employee in the subcontractor has, or has had, an ownership or control interest in the 3-year period preceding disclosure; and

ii. Any penalties, assessments or exclusions under Medicare incurred by the subcontractor, its owners, managing employees or those with a controlling interest in the subcontract.

3. **State Regulations Regarding Licensure.**

a. State regulations may define conflicts or require that organizations address potential conflicts of interest.

b. For example, Connecticut's licensure regulations have relevant requirements.

i. **Assisted Living Services Agency.** The governing authority of an assisted living services agency must adopt bylaws or rules that

contain a conflict of interest policy and procedures. Conn. Agencies Regs. 9-13-105(d)(1)(E).

ii. **Nursing Homes.** The governing authority of chronic and convalescent nursing homes and rest homes with nursing supervision must adopt a written policy about potential conflicts of interest of directors (members of the governing body), the administration, medical and nursing staff, and other employees who might influence corporate decisions. Conn. Agencies Regs. 19-13-D8f (e)(2)(K).

4. **Other Antitrust Considerations.** Maintenance of confidentiality of information will in certain circumstances be particularly important. For example, a network of competitors organized for managed care contracting must be cautious not to permit the exchange of price information.

5. **Organization's Policies and Documents**. The organization may have relevant provisions in its certificate of incorporation and bylaws (or other organizational documents) as well as policies or protocols setting standards or providing rules of conduct.

6. **Religious or Ethical Directives**. Organizations with religious, fraternal, or other affiliations may also have religious, ethical, or other standards prescribing or defining conduct as well as conflicts or ethical principles.

III. HOW CONFLICTS CAN ARISE

A. **Personal Financial Interest.** Classic conflicts of interest arise when a director or a close relative of a director has an ownership interest in (or employment relationship with) another entity proposing to do business with the corporation, or when a top employee uses his influence to extract excessive compensation or benefits from the corporation.

1. **Sibley Hospital Case**. The landmark case illustrating the first situation is Stern v. Lucy Webb Hayes National Training School for Deaconesses and Missionaries, 381 F.Supp. 1003 (D.D.C. 1974).

a. This was a class action against the directors of the Hospital, banks, and nominally Sibley Hospital itself in which the Hospital's patients alleged, among other things, breaches of duty by the directors. The claims included mismanagement, nonmanagement, and self-dealing.

i. Substantial amounts of the Hospital's liquid assets were invested in savings and checking accounts at banks with which the directors were affiliated and drew little or no interest. The Hospital directors were variously directors, employees, and shareholders of the banks.

ii. The Hospital directors did not disclose their relationships with these institutions to the Hospital's Board.

iii. The Investment and Finance Committees of the Hospital Board did not meet for years.

b. The case had several important holdings.

i. Although an individual who is a director, employee, and/or shareholder of a bank is not automatically prohibited from serving as a hospital board member, transactions between the hospital and the bank should be carefully scrutinized.

ii. A director violates his/her duty if:

- While on a committee the director fails to exercise due diligence;
- The director knowingly permits the hospital to enter into transactions with institutions with which he or she is connected without disclosing his or her interest as well as any reasons why the transaction might not be in the hospital's best interests;
- The director actively participates in or votes on issues in which he or she has an interest; and
- The director fails to act honestly, diligently, and in good faith.

c. The directors were found liable for breach of fiduciary duty for, among other things, failing to make full disclosure of their interests.

2. **Desert Hospital Case.** An egregious example of a breach of fiduciary duty by board members involved two physicians who were members of the board of directors of Desert Hospital in Palm Springs, California.

a. The Hospital alleged that the two physician directors (former medical staff presidents) had "breached their fiduciary duties while sitting on Desert's board of directors, by stealing proprietary information and using it to establish their own businesses in direct competition with the Hospital's proposed ventures." 71 *Medical Economics* 3, at 60 (February 7, 1994).

b. In October, 1995, after a jury trial, the Hospital was awarded $11.8 million in compensatory damages and $1.8 million in punitive damages. *Modern Healthcare* (October 23, 1995).

c. This is a classic case of usurpation of a corporate opportunity and the improper use of confidential information.

3. **Adelphi University**. Allegations of excessive salary and self-dealing regarding the president of Adelphi University led to an investigation by the New York State Board of Regents and the New York Attorney General's office. The Regents eventually removed eighteen of the nineteen Adelphi trustees for improper self-dealing, failure to investigate the president's actions, and failure to take remedial action to correct abuse. Neglect of duty and misconduct by the trustees included:

   i. providing the president with a compensation package exceeding that of any other university president while the school faced serious enrollment problems;

   ii. allowing Adelphi's insurance business to go to an insurance brokerage firm of which the Board chair was an owner; and

   iii. allowing another trustee's law firm to receive over $100,000 in legal fees even though that firm had committed to provide the services free of charge.

   In Adelphi University v. Board of Regents, 647 N.Y.S.2D 678 (NY. Sup. 1996), the Court determined that the University could not stop the State Board of Regents from conducting the hearing on the claims.

4. **Anclote Psychiatric Center**. The U.S. Tax Court held that the IRS properly revoked the tax exemption of a section 501(c)(3) organization.

   i. In 1993, Anclote had sold its assets to a for-profit company owned by its former board members for substantially less than its true fair market value.

   ii. The court found that the sale price was approximately $1.2 million less than the value of the assets sold and thus was not within the "reasonable range" of fair market value.

   iii. Today, the IRS would have the power to force the return of any "excess benefits" received by the directors through hefty section 4958 penalty excise taxes imposed on the directors both as disqualified persons and as organization managers.

   Anclote Psychiatric Center, Inc. v. Commissioner, T.C.M. (CCH) 1998-273, Aff'd, 84 A.F.T.R. 2D ¶ 99-5153 (11th Cir. 1999).

5. Other cases involving allegations of conflicts of interest with trustees and insiders include the Sta-Home Health cases mentioned earlier and the Bishop Estate case in

Hawaii, in which the trustees of a trust created by the last Hawaiian Princess were accused of serious breaches of duty.

6. Personal financial interests are also implicated when the board of directors determines the compensation of a director or a close relative of the director. Here, of course, intermediate sanctions come into play.

B. Non-director Employees. Employees who are not directors of a corporation may have conflicts of interest as well.

1. Employees may have a personal or financial relationship with another entity that competes with the corporation, or seeks to do business with the corporation.

2. Employers can reasonably expect that their employees will not act competitively or in an otherwise harmful manner toward them.

3. The employee handbook or personnel manual should clearly state each employee's duty of loyalty to the employer.

4. A conflict of interest could arise when an employee accepts personal gifts, expensive entertainment or favors from an entity that does business with, or is trying to do business with, the organization. Many organizations have developed policies as part of their compliance programs prohibiting employees from accepting gifts, favors and entertainment of more than nominal value. Accepting gifts, favors and entertainment from entities seeking referrals of Medicare and Medicaid business could also be construed as a violation of the federal Anti-Kickback law. In fact, the OIG specifically referenced this issue in its compliance guidance for nursing facilities.

C. Holding Board Positions on Related or Affiliated Entities.

1. Board members of one corporation may hold positions on the board of a related or affiliated entity.

2. Transactions or contracts with the related or affiliated entity may conflict with the corporation's interests.

D. Director on a Board Representing or at Request of Another Organization.

1. "A board may be selected by divided constituencies, giving rise to special obligations …. There are situations where a board may be explicitly structured to provide for representation of certain interests." ABA GUIDEBOOK, *supra* at 42.

   - "In such situations, a director may be faced with a conflict for which the law, as yet, provides no clear answer.

- The law imposes common responsibilities, powers, and duties on all directors to further the corporate mission. However, wise governance often suggests that a nonprofit board be purposely structured to ensure that the views of all differing interests are heard and considered. This can create a conflict in the demands on the director.

- The director, in bringing to the attention of the board the particular sensitivities and concerns of his or her constituency, is aiding the whole board in the Duty of Care, and adding wisdom to the whole board's deliberations; but the Duty of Loyalty is loyalty to the corporation's overall interests, to the corporate entity itself, and not to the constituency as a separate source of obligation. "

ABA GUIDEBOOK, *supra* at 43.

2. A network is a good example of this type of representative board.

E. <u>Trade Associations</u>.

1. The boards of trade associations are generally structured to require representation of certain interests.

   a. Persons serving on the board of directors of the trade association have been selected because of their own interests, employment, and experience.

   b. For example, the board of directors for a state association of long term care providers may be composed of employees and directors from each member facility.

   c. Members of the association's board will have potential conflicts of interest in many of the transactions or contracts entered into by the association.

2. The law does not yet provide a clear answer on how to address potential conflicts in these situations.

IV. TOOLS

A. <u>Development of Policies Acknowledging the Issues</u>.

1. Corporations should develop a conflict of interest policy to protect the corporation's interests when contemplating entering into a transaction or arrangement that might benefit the private interest of an officer or director of the corporation.

a. Conflicts of interest policies are intended to supplement, not replace, applicable state laws governing conflicts of interest.

b. The purpose of the written policy should be:

i. To assure the institution of the good faith and integrity of its officers and governing board members, and

ii. To provide a systematic and ongoing method of assisting individuals in disclosing and resolving potential conflicts of interest.

AMERICAN HOSPITAL ASSOCIATION, MANAGEMENT ADVISORY: RESOLUTION OF CONFLICTS OF INTEREST 1 (1990).

2. The IRS has opined that a conflicts of interest policy should include the following provisions:

a. "Disclosure by interested persons of financial interests and all material facts relating thereto;

b. Procedures for determining whether the financial interest of the interested person may result in a conflict of interest;

c. Procedures for addressing the conflict of interest after determining that there is a conflict:

i. Requiring that the interested person leave the meeting during[, or at least abstain from participation in,] the discussion of, and the vote on, the transaction or arrangement that results in the conflict of interest;

ii. Appointing, if appropriate, a disinterested person or committee to investigate alternatives to the proposed transaction or arrangement; [and]

iii. Determining, by a majority vote of the disinterested [directors] present, that the transaction is in the organization's best interests and for its own benefit; is fair and reasonable to the organization; and, after exercising due diligence, determining that the organization cannot obtain a more advantageous transaction or arrangement with reasonable efforts under the circumstances."

IRS EXEMPT ORGANIZATIONS DIVISION, CONTINUING PROFESSIONAL TECHNICAL INSTRUCTION PROGRAM

TEXTBOOK FOR FY 1997, at 21-22 (1996) (hereinafter "1997 IRS TEXTBOOK").

d. "Procedures for adequate record keeping. The minutes of the board meetings and all committee meetings should include:

i. The names of the persons who disclosed potentially conflicting interests, the nature of the [potentially conflicting] interests, and whether the board determined there was a conflict of interest; and

ii. The names of all persons present for discussions or votes relating to the transaction or arrangement; the content of these discussions, and a record of the vote."

1997 IRS TEXTBOOK, *supra* at 22.

e. "Procedures ensuring that the policy is distributed to all [directors], principal officers and members of committees with board-delegated powers. Each such person should sign an annual statement that he or she:

i. Received a copy of the conflicts of interest policy;

ii. Has read and understands the policy;

iii. Agrees to comply with the policy; and

iv. Understands that the policy applies to all committees and subcommittees having board delegated powers."

1997 IRS TEXTBOOK, *supra* at 22-23.

f. Procedures for applying the policy to a compensation committee (for tax-exempt organizations). 1997 IRS TEXTBOOK, *supra* at 23.

3. Long term care providers should incorporate conflict of interest policies and principles into their compliance programs. For example, many organizations include avoidance of conflicts of interest in their "code of conduct" or "business ethics guidelines" for employees, officers and directors of the organization and address conflict of interest issues in compliance training.

B. <u>Disclosure</u>.

1. Generally, disclosure should occur in two situations:

a. Annual disclosure

i. Corporations should require each trustee, officer and employee who is in a position of control or is involved in policy-making decisions, to sign the conflicts policy and complete a conflicts questionnaire on an annual basis.

ii. Sample disclosure forms are provided with the policies attached as Tabs B and C.

b. Whenever a conflict of interest arises.

2. Rule: When in doubt, disclose.

3. As conflicts of interest arise:

a. Directors should disclose the conflict before the board takes action on the matter. ABA GUIDEBOOK, *supra* at 29.

b. "The duty of disclosure of an interest exists without regard to whether the proposed transaction is fair, or whether the director urges or opposes the transaction, or whether the director is present during discussion of the transaction, votes thereon or abstains from voting, or is counted or not counted in establishing a quorum at any meeting where the transaction is discussed." ABA GUIDEBOOK, *supra* at 30.

c. "[M]any statutes uphold the validity of a transaction authorized even when a director had an undisclosed interest therein, if the transaction was 'fair.'" ABA GUIDEBOOK, *supra* at 30.

- However, in the event of litigation, the nondisclosing director (and sometimes even the disinterested directors who supported the transaction) will have the burden of proving fairness. *Id.*

d. At times, a director's fiduciary duty to another person or organization may prevent him or her from disclosing the nature of the conflict. In such cases, the director should at least state that such an interest exists, consider leaving the meeting, or at least abstain from the discussion and not vote thereon." ABA GUIDEBOOK, *supra* at 30.

4. The Board should establish procedures to ensure that annual disclosures are made according to the organization's conflict of interest policy and procedures.

a. Many organizations merge this responsibility into their compliance program, making the compliance officer responsible for managing the annual disclosure process for employees and, in some cases, directors.

b. An organization may choose to vest an individual director (e.g. board chairman) or committee with responsibility for managing the annual disclosure process for directors.

C. Disinterested Review and/or Removal.

1. Upon disclosure by the director, the board should provide a disinterested review of the matter. ABA GUIDEBOOK, *supra* at 29.

2. In certain circumstances it may be appropriate for the interested director to remove him or herself from the discussions about the conflicting interest transaction.

   - This poses a problem in a network or system. Removal is often not an option in such cases because everyone has a preexisting obligation to their employer.

D. Awareness.

1. Directors must be sensitive to any interest they may have in a decision to be made by the board and, as far as possible, recognize the interest prior to the discussion or presentation of the matter before the board. ABA GUIDEBOOK, supra at 29.

2. Corporations must educate board members and employees about conflicts of interest.

3. Corporations should hold an orientation for new employees and board members and should include, at least annually, a discussion of conflicts of interest in the board's agenda.

E. Adopt Strategies to Reduce the Likelihood of Unidentified/Unmanaged Conflicts.

1. Choose board members with diverse backgrounds and interests. Maintain enough members so that one person or faction will not be able to dominate the board.

2. Regular turnover and term limits will facilitate a fresh look at whether the organization's contracts and business arrangements serve the organization's best interests, as opposed to the private interests of the board members or staff.

3. Lines of authority and board committee structure will encourage a sharing of power among people with diverse perspectives and economic interests.

Pamela A. Mann, New York Practice Skills Course Handbook Series, 34 (PLI Order No. F0-0001 November 1998) W, Nonprofit Governance: Duties, Conflicts, and Liabilities.

F. The Critical Importance of Monitoring.

1. Conflict of interest questionnaires will be useless if:

   a. Directors are not required to return them;

   b. There is no mechanism to ensure that directors are appropriately disclosing potential conflicts;

   c. There is no person or committee ensuring that conflicts are appropriately disclosed when a potential conflict arises; or

   d. No one ensures that conflicts are periodically monitored.

2. As discussed earlier in the Section on Disclosures, one effective way to formalize monitoring of annual disclosure of conflicts of interest and compliance with the

conflicts of interest policy is to incorporate that function into the organization's compliance program.

a. The organization should also ensure that an individual or committee has clear responsibility to monitor conflicts or potential conflicts that may arise at both at the board and employee levels.

b. At the board level, an individual board member or committee should be charged with responsibility for knowing what individual board members have disclosed in their annual disclosure forms. In the event an issue arises and a director does not disclose his or her interest (e.g. the director could be absent, or not focused on the interest), then the potential conflict can be raised and considered in a timely fashion.