

Conflicts of Interest: Status Quo Isn't Good Enough

There's a major storm heading toward many not-for-profit hospital and health system boardrooms and preparations for dealing with it have been inadequate. The approaching storm has to do with the way in which conflicts of interest are handled by tax-exempt organizations. Most boards and their legal counsels treat conflicts of interest as a routine, manageable issue that requires compliance with the law but not one where fundamental change may be needed. The "let a sleeping dog lie" attitude concerning conflicts of interest is an artifact left over from the "good old days" of board service. Today, some board members continue to view their service on the board as a business opportunity and many boards and senior executives see nothing wrong with rewarding board members for their service by steering business to them. As one board chair recently said to me, "If you can't give business to your loyal supporters, including board members, to whom can you give it?"



Edward A. Kazemek
Chairman & CEO
ACCORD LIMITED
Governance Advisor,
The Governance Institute

Winds of Change

Unfortunately or fortunately (depending on one's point of view), the storm clouds have been gathering and the winds of change are blowing pretty hard. Consider the following forces for change over the past five years or so:

- Enron and a long list of other corporate scandals resulted in the Sarbanes-Oxley Act, fast becoming a source of best practices for hospitals and health systems, encouraged by recent positions taken by the bond rating agencies (e.g., Moody's and Fitch).
- Tax exemption challenges on the part of governmental units continue to increase across the country, with accompanying negative publicity and hearings by congressional committees.
- Class action lawsuits filed over hospital and health system billing and collection practices.
- The IRS examination of compensation matters, including the proposed changes to the Form 990 beginning in the 2005 tax year, which will require more detailed information on executive and board member compensation and benefits.
- The Senate Finance Committee's work over the past year, aided by the reports of the Independent Sector, expected to result in legislation with significant impact on the governance practices of tax-exempt organizations.
- Heightened attention on the part of state attorneys general regarding their oversight role of not-for-profit corporations.

Conflict-of-Interest Guidelines

From time to time, some board members may find themselves in periodic situations subject to the organization's conflict-of-interest policies and procedures. Handled properly, these occasions may not give rise to any undue concern about the integrity of the board. However, the organization's board could decide that some situations may disable a board member from serving as a fiduciary board member for the organization. Situations that could result in a board member stepping down from the board include the following:

1. Failure to adhere completely to disclosure requirements and conflict-of-interest policies.
2. Board member is an owner, partner, employee, board member, or investor in a direct competitor of the organization.
3. Board member is an employee of the organization, or a family member is a senior executive officer for the organization.
4. Board member receives direct compensation for ongoing services provided to the organization (serving as a "de-facto employee").
5. Board member is an owner, partner, employee, board member, or investor of a vendor (professional services, financial institution, or other business) receiving a substantial amount of revenue from the organization—the greater of \$200,000 or 2 percent of the annual revenues of that vendor in the preceding or current year.

Taken together, all of these events translate into relentless pressure for greater accountability and transparency on the part of hospital and health system boards. Most boards need to address tough questions now rather than waiting to become the target of a governmental investigation or a negative story in the local press. For example, how much business should a board member do for the organization before he/she becomes "disabled" and should no longer serve on the board? How independent are the board members who serve on sensitive committees like the executive compensation, nominating, and audit committees? Has the organization bothered to define in concrete terms what it means by "independence?"

continued on next page

Case Example: Jewish Hospital Healthcare Services

These are some of the questions that the board of Jewish Hospital Healthcare Services (JHHS) recently addressed, with assistance from the author.¹ Carole Shomer, Vice President for Corporate Compliance, described what the board wanted to accomplish: “Our board was interested in developing more effective governance structures and in creating policies to ensure that the governance practices of our system were above reproach, including eliminating the gray areas around conflicts of interest.”

The board delegated the task to its Compliance & Governance Committee, chaired by Robert L. Taylor, professor and dean emeritus of the Business School at the University of Louisville. Given his background and academic position, Dr. Taylor was very familiar with the challenges and practices emerging in the private sector and wanted to adapt some of the more useful practices to JHHS’ governance situation. “The bottom line for our committee was to make sure that we ended up with the best governance structures and practices, especially with regard to questions of conflict of interest and independence. We were determined to demonstrate the board’s integrity to the diverse communities we serve and facilitate effective governance of our complex health system,” Taylor explained.

Independence Standards

An “independent” director *does not have any direct or indirect material relationship* with the organization. A board member will not be classified as independent by the organization if any of the following apply:

1. Any individual providing personal/professional services to the organization or to a member of the organization’s senior management within the preceding or current year for fees in excess of \$60,000 per year.
2. An owner, partner, board member, employee, or paid advisor of a professional services firm (e.g., law firm, accounting firm, insurer, underwriting firm, commercial bank, information technology consultant, management consultant, etc.) or other business enterprise that has provided services or sold goods to the organization or to a member of the organization’s senior management within the preceding or current year in excess of \$60,000 or 1 percent of the annual revenues of the supplier/company or, whichever is greater.
3. An immediate family member of any individual described above.

Over a three-month period, the committee debated various proposals for change and engaged the full board at critical points in its work by securing feedback on some of the ideas that were being considered. Shomer and Taylor summed up their thinking on how to engage the board in making decisions on potentially sensitive matters: “We didn’t want to get too far ahead of the board so our approach was to incorporate education on the issues we were reviewing with the board so they could better evaluate the committee’s proposals.”

The approach worked. Approximately five months after the committee began its work, the JHHS board approved a dramatic overhaul of its corporate structure and adopted state-of-the-art guidelines and standards concerning conflicts of interest and independence. (See sidebars for the conflict of interest and independence guidelines approved by the board.) Some of the board members adversely affected by the new guidelines tested the decisions at board meetings but, in the end, the vast majority of board members endorsed the changes.

Creating measurable guidelines on conflicts of interest and defining what it means for a board member to be independent are controversial issues for a board to tackle. JHHS was not doing anything inappropriate under its old policies but was determined to set a higher bar for itself.

Given the challenges described at the beginning of this article, all hospital and health system boards should ask themselves the questions that Jewish Hospital Healthcare Services asked and answered:

- Are we completely comfortable with the number of conflicts of interest we experience on our board and the way we handle them? If not, what needs to change?
- Is there a point where a board member’s conflicts of interest disable him/her from serving on our fiduciary board? If yes, what measurable standards should we apply?
- In light of the demand for independent board members to serve in leadership positions and on key committees, how do we define independence? What metrics should we use? Can a board member have an occasional conflict and still be independent?

The time to start working on answers to these questions is now. The storm is coming.

Look for a companion article in our February issue, which will continue this topic in an interview with Roger Longenderfer, M.D., president & CEO of Pinnacle Health System, whose system board recently re-wrote its conflict-of-interest policy and created a detailed board member questionnaire for determining independence.

¹ JHHS is a large multi-hospital system in Louisville, Kentucky that recently expanded its system by joining forces with a smaller Catholic system in the Louisville market.