Readings in Health Care Governance

It's Chubb. Or it's Chance.
**TABLE OF CONTENTS**

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction</td>
<td>2</td>
</tr>
<tr>
<td>Health Care Boards: Reenergize, Reorganize, and Reduce Risk</td>
<td>3</td>
</tr>
<tr>
<td>Duties of Not-for-Profit Directors and Officers and the Role of the Health Care Risk Manager</td>
<td>7</td>
</tr>
<tr>
<td>Complying with the Sarbanes-Oxley Act</td>
<td>12</td>
</tr>
<tr>
<td>Health Care Not-for-Profits Under the IRS Looking Glass:</td>
<td>19</td>
</tr>
<tr>
<td>Lessons for Tax-Exempt Entities</td>
<td></td>
</tr>
<tr>
<td>Trends in Health Care Governance</td>
<td>24</td>
</tr>
<tr>
<td>Proactive Governance Checklist</td>
<td>27</td>
</tr>
</tbody>
</table>
INTRODUCTION

Contemporary health care is under scrutiny from regulatory bodies, the courts, and consumers. From patient safety to calls for pay for performance, the pressure is on health care organization leadership. Board of trustees members now expect prudent spending and good organization stewardship from the leadership team.

The operative word today is “governance.” Taken from the pages of STAT, Chubb Health Care’s quarterly risk management publication, and Chubb on-line resource material, Readings in Health Care Governance provides timely information for board members who are obliged to fulfill their governance leadership responsibilities. Geared to not-for-profit board members, these articles offer risk management strategies to help minimize trustee liability.

Included in this booklet are articles on board organization structure, the duties and responsibilities of directors and officers in not-for-profit health care, applying the principles of the Sarbanes-Oxley Act to not-for-profit health care, tax-exempt status for not-for-profit health care organizations, and developing trends in governance.

In addition, the booklet includes a convenient Governance Checklist. The checklist provides practical reminders of key points in governance from a risk prevention perspective.

Governance is an evolving topic in the health care field. It is hoped that Readings in Health Care Governance will help health care leaders in meeting their responsibilities.
Health Care Boards: Reenergize, Reorganize, and Reduce Risk

By Sharon McNamara, BSN, CPHRM, CHC, JD
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Most hospital boards of trustees or directors are comprised of volunteers, influential community business owners, some physicians, and a few hospital administrators. This eclectic group is expected to set the strategic direction for the enterprise for years into the future. Many not-for-profit hospitals have long assumed that unpaid board members faced limited directors’ liability exposure. Recent attention regarding corporate board members who did not fulfill their fiduciary duties has caused many not-for-profit health care organizations to rethink this position. Such concern is well-placed as health care organizations examine their boards with a critical eye and make lasting changes to reduce growing liability exposure. These changes will serve the health care enterprise well and assist board members in discharging their responsibilities.

Risk Areas for Hospital Directors

Board members owe a fiduciary duty to the hospital or health care enterprise they serve. According to Directors and Officers Liability Loss Prevention Guidelines for Not-for-Profit Organizations, a booklet written for Chubb by directors and officers (D&O) liability expert Dan Bailey, board members are subject to three basic duties in performing their responsibilities:

1. Duty of diligence. Board members must act with the care that a reasonable prudent person in a similar position would use under similar circumstances.

2. Duty of loyalty. Board members may not engage in personal activities that would injure or take advantage of the organization.

3. Duty of obedience. Board members must perform their functions in accordance with applicable statutes and the terms of the organization’s bylaws.

In short, board members owe a fiduciary duty to the hospital or health care enterprise they serve.

General fiduciary responsibilities include:

- Understanding the business.
- Keeping informed about operations.
Monitoring corporate activities.

Monitoring finances, receiving and reviewing reports.

Inquiring into matters that are unclear.

Avoiding illegal activity.

Acting in the best interest of the company.

Avoiding conflicts of interest.

State laws may provide statutory immunity for directors for breach of fiduciary duty and for participation in peer review actions. For hospitals, there is also some federal peer review protection in the Health Care Quality Improvement Act. However, there is a growing trend toward holding directors accountable for negligent acts. Not-for-profit directors should be aware of this trend and take advantage of any available state protection.

Common Problems and Solutions

Several common problems have been identified that can increase board liability exposure and reduce the effectiveness of the members to accomplish their responsibilities. One problem common to many health care boards is an excessive number of members. As health care communities and health systems have grown, so has the size of their governing boards. Increased numbers may mean more frequent and lengthier meetings. Larger boards also pose a challenge to achieving a quorum, a key component in making critical decisions. Divergent opinions may cause delays in decision making. The end result is an inefficient board that may not meet strategic objectives.

A second problem is too many committees. Numerous committees with overlapping responsibilities and reports can create chaos. Important policies may be delayed or even tabled as they wind their way through a maze of committees that have approval authority. Committee turf wars can derail the smooth flow of information and upset operations.

A third common problem is directors who are passive listeners. A health care organization board needs directors who are active and committed to fulfilling their roles. Engaged board members are more likely to review all materials, attend all meetings, and be team players who get things done.

The fourth commonly seen problem, and the most important, is an inadequate skill set among board members. Keeping the health care organization financially viable in a world of shrinking reimbursements is
critical. Choosing, compensating, and evaluating corporate executives who will lead a high-quality enterprise is equally important. Responding to ever-changing laws and regulations is a continuing expectation. Understanding the health care business and its opportunities and risks takes time and education. Every board member must be chosen for the value he or she can bring to key decisions. Financial, legal, and medical skills are important, but team building, creativity, and critical thinking are also valued assets.

**Refine Board Operations**

To overcome these common problems that impair boards, several steps should be considered. At the very least it is prudent to _streamline the board's membership and committee structure._ Just as management and medical staff members are subject to performance-based review, the board should take the time to review its actions every year.\(^2\) This means developing and implementing a process that evaluates its performance along with that of the CEO.

In addition, to manage liability exposure, the board should consider adopting practical risk management strategies, including the following:

- Work toward building a highly skilled board with specific expertise in health care.
- Create an atmosphere of active engagement.
- Commit to ethical business practices.
- Provide orientation and ongoing education programs for board members on key issues.
- Eliminate conflicts of interest with an excellent screening and disclosure policy.
- Record board actions consistently, using available statutory and peer review protections.
- Develop a policy addressing retention and destruction of documents.
- Provide appropriate D&O liability insurance coverage and indemnification.

**Conclusion**

As the steward of the health care organization, the board bears a significant responsibility for the financial well-being and integrity of the enterprise.
Setting and maintaining a course requires persistence in following accepted business practices. This is as true for other industries as it is for the highly regulated health care field. Adopting practical risk management strategies will help strengthen such an approach for contemporary health care organizations.

1 The HCQIA is found at 42 U.S.C.§11111.
2 Many associations have resources to help health care organizations evaluate and improve their governing boards.
Duties of Not-for-Profit Directors and Officers and the Role of the Health Care Risk Manager

By Mary Danner, RN, MS, CPHRM
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Recent publicized events regarding misuse of corporate funds for personal gain by directors and officers of publicly traded companies are poignant examples of entrusted leaders failing to fulfill their obligations to act in the best interests of the corporations they serve. Without a doubt, executive liability is a potential threat for all health care corporations regardless of their profit status. Health care risk managers of not-for-profit organizations are well-advised to develop an understanding of executive duties and liability exposures and to assess the vulnerability of their own organizations to the potential losses associated with directors and officers (D&O) liability.

Not-for-profit corporations are typically created for charitable, religious, educational, literary, or scientific causes. As such, they are afforded access to special funding, tax exemptions, and the use of tax-deductible charitable donations. Given their dependence on statutorily awarded commitment to their higher purpose, not-for-profit corporations face a significant risk of self-destruction if executive misconduct is tolerated.

The purpose of this article is to highlight the legal duties of directors and officers of not-for-profit health care organizations, the potential areas of liability for organizations, and the risk manager’s role in protecting the organization from losses associated with the activities of its directors and officers.

Background

Health care governance boards are typically comprised of inside directors, such as the CEO, and 12 to 15 directors from outside the organization with a variety of backgrounds and motivations for serving. These outside directors often bring specific skills and expertise to the organization such as law, business, insurance, or not-for-profit governance. Other members may consist of community laypersons that possess either fundraising talents or lend their “celebrity status” to a worthy and visible endeavor. The latter are particularly vulnerable to not fully appreciating or understanding the responsibility of the board of directors for the oversight of the corporation’s activities. But regardless of their background and motivation, all directors and officers must display such qualities as integrity and the ability to exercise...
independent judgment, have sufficient time and interest to devote to the job, and commit to acting in the best interests of the corporation.

In addition to possessing talent and motivation, directors and officers should have an understanding of the specific legal duties that, if unfulfilled, could result in a liability exposure. Common allegations against directors and officers include:

- Failure to perform their duty.
- Neglect of duty.
- Misconduct in connection with certain conflict-of-interest transactions.

The cost of such claims to the organization may be severe and include litigation expenses and monetary fines, payments, settlements, and possible loss of not-for-profit status. Monetary losses may be compounded by indirect damages to the organization resulting from the harm to corporate reputation, emotional toll on personnel, and interruption of normal business. Risk managers can minimize the potential for financial loss from D&O liability claims by educating board members on their duties and responsibilities.1

**Duty of Care**

Directors and officers are charged with the duty to act in good faith and in the best interest of the corporation. Acting “in good faith” means making business decisions after considering all material information that is reasonably available. The good faith standard is defined as what an ordinarily prudent person in a comparable position would do under similar circumstances.2 This duty can be onerous in today’s complex health care environment, and directors and officers often rely on administrators, legal counsel, risk managers, and outside experts to supply the requisite information on health care standards and compliance with a myriad of applicable laws and accreditation requirements. Most state not-for-profit corporation acts acknowledge the need for directors and officers to be able to rely on expert reports, opinions, financial statements, and other information, provided that the experts are qualified by their expertise and training, provide advice within the scope of their expertise, and do not have a personal interest in the action under consideration by the board.

Risk managers can help directors and officers fulfill their duty of care by
encouraging the development of governance policies that enhance their knowledge and provide information on corporate matters. Components to consider include:

- Assisting senior management in the development of orientation packets, complete with the organization’s mission statement, strategic plan, annual goals, objectives, and vision statement.³

- Providing directors and officers with the organization’s bylaws and the medical staff bylaws and rules prior to their first meeting.

- Setting clear expectations of regular attendance at board and committee meetings.

- Ensuring that all management materials, reports, and committee meeting minutes are provided to the directors for their review well in advance of board meetings.

- Educating the board on changing regulatory issues and accreditation requirements.

- Providing regular reports on the organization’s liability, risk retention, and risk transfer, including its insurance program and risk management activities.

- Facilitating the performance of annual board and CEO evaluations. In addition, risk managers should review annual organizational goals and objectives and minutes of board and committee meetings to get a “heads up” on areas of potential risk, such as mergers and acquisitions.

**Duty of Loyalty**

Directors and officers should not engage in personal conduct that could injure the corporation’s reputation or financial well-being. Since directors are in a position of trust and have access to confidential corporate information, they must resist any temptation to misuse their position for their private interests or personal gain. Internal Revenue Service rules prohibit directors and officers of not-for-profit entities from engaging in activities for their personal benefit, such as receiving remuneration. Similarly, state not-for-profit corporation acts frequently prohibit conflicts of interest for directors.⁴ Conflicts of interest can arise when a director “is a party to a transaction with the corporation, when a person who is related to the director is a party to the transaction, or when a third party (such as the director’s employer or an entity of which the director serves as a director) is a party to the
Examples include a director insurance agent who earns a commission on the sale of insurance to the corporation; a director who is the spouse of a staff physician who votes to approve the purchase of capital equipment that would directly benefit the physician's practice; and a director whose employer reaps material benefits as a result of a corporate sale or contract. However, not all conflicts of interest are necessarily detrimental to the corporation. Nonetheless, directors need to be extremely careful and forthcoming to avoid the appearance of personal gain by making a full disclosure of any potential conflict to the board. If, after full disclosure, the board elects to pursue the activity, the director with the potential conflict should remove himself or herself from any further discussion and refrain from voting on the matter. The board minutes should accurately reflect the discussion and subsequent action.

Risk managers should ensure that, on an annual basis, each director reviews and signs a “Code of Conduct and Resolution of Conflicts of Interest” statement. The document should remind directors of their responsibility to exercise due care and judgment for the benefit of the corporation and prohibit material conflicts of interest. In addition, some experts suggest that the statement should also prohibit acceptance of gifts or favors that might adversely influence a director’s decision making or actions to the detriment of the corporation.

**Duty of Obedience**

Directors and officers are responsible for ensuring that their own conduct and the corporation’s activities are in compliance with state and federal statutes and the corporate charter and may be held liable if a corporate action is either illegal or outside the organization’s authority. In the event of a lawsuit, monetary penalties and/or fines may be imposed under the federal sentencing guidelines that require employers to implement a corporate compliance program to detect violations of law. The board is ultimately responsible for overseeing the condition and effectiveness of the corporate compliance program. Risk managers along with legal counsel play a crucial role in educating the board about the status of their compliance with regulatory issues, accreditation guidelines, and local ordinances.

All board and committee discussions and deliberations should be clearly and accurately recorded and retained indefinitely. Documentation is one of the simplest and most effective, yet most often neglected, risk control strategies. Meeting minutes should reflect an accurate recording of all board actions.
and/or deliberate inactions, including the rationale for decisions. Any documents reviewed in connection with a decision should be attached to the minutes. A tally of each vote, along with any dissent, should be recorded. Risk managers should ensure that written guidelines exist that prevent the destruction of these important documents. The health care environment has become increasingly complex, and organizations are faced with a wide array of exposures. Executive liability is a perennial threat for corporations, large and small. In addition to potentially huge litigation damages, expenses, and distractions, exposure fears can inhibit decision making and result in the loss of significant corporate opportunities. Although a comprehensive D&O liability insurance policy will go a long way toward reducing these exposures, today’s directors and officers face risks greater than insurance coverage alone can address. Risk managers are charged with being proactive and implementing proven risk reduction strategies to protect their organizations. What better place to start than at the top?

1 Sylvia Brown, JD, *The Risk Manager Educates the Board: Meeting the Challenge*, Journal of Healthcare Risk Management, Fall 2000, at 52-60.
4 Id. at 1.
5 Id. at 1.
6 Id. at iii.
Complying with the Sarbanes-Oxley Act

By Mary Danner, RN, MS, CPHRM
Risk Manager, Chubb Health Care

In the wake of several highly publicized corporate accounting scandals, Congress enacted the Public Company Accounting Reform and Investor Protection Act of 2002 (Sarbanes-Oxley Act). The Act was designed to protect investors by setting forth the responsibilities that public company directors and officers now have for the overall integrity of the auditing process and the accuracy of company financial reports and statements.

Although specifically targeted at publicly traded companies, Sarbanes-Oxley contains several provisions that are transferable to the not-for-profit health care organization. Savvy health care executives are embracing some of the emerging best corporate governance practices into their organizational bylaws and corporate compliance programs. In the end, this will serve to boost public confidence that health care trustees and executives are fulfilling their fiduciary duties in an honest, ethical manner.

This article will highlight some of the Act’s fundamental provisions that will likely serve, in the not-too-distant future, as the new governance model for not-for-profit entities. This information is intended to spur health care trustees and executives to conduct a meaningful self-assessment of how well their organization is prepared to be accountable for the increased expectations of honest and ethical leadership.

Board and Senior Management Responsibilities

Sarbanes-Oxley requires that the organization have a written code of ethics to deter wrongdoing and to promote honest, ethical conduct, which includes avoiding even the appearance of conflicts of interest. Board members must be diligent about divulging actual or potential conflicts of interest as they relate to their obligation to protect the interests of the organization. Board members must remain independent of the organization and avoid any personal behaviors or activities that could jeopardize their objectivity or incur a personal benefit at the expense of the organization’s well-being.

Following are suggested activities to minimize conflict-of-interest issues:

- Review your organization’s mission and value statements to ensure that they articulate a commitment to providing health care services in a fiscally responsible and ethical business manner. When written in a meaningful way, both the mission and vision statements serve to guide
the board and the organization’s officers toward achieving their objectives in a morally sound manner.

- Review the organization’s strategic plan, and establish key performance indicators to assess the leader’s progress towards achieving its goals. Monitor and evaluate at least annually.

- Review the qualifications of board members to ensure that each member has the proper amount of education and experience to effectively interpret and monitor the financial reporting process. Require that at least one board member be experienced in financial matters and have a good understanding of generally accepted accounting principles. Provide for continuous board education on financial issues.

- Ensure that the board bylaws reflect, and that the composition of the board demonstrates, a commitment to ensuring the independent status of the board with respect to the senior management team.

- Review the nomination process for the selection of new board members to ensure full disclosure of any potential conflicts of interest and a commitment to maintaining members’ independence. Revise the conflict-of-interest form to include a prohibition on the use of corporate assets for personal gain or the dissemination of confidential business information.

- Consider limiting board member terms to ensure rotation, and a fresh perspective, and to discourage long-term associations that leave room for the temptation to abuse power.

- Develop a meaningful policy for managing actual or potential conflicts of interest. This should include a commitment to forthright communication about the conflict, as well as guidance for when a member should abstain from voting on any decision or participating in a discussion.

- Develop a policy to prohibit the organization from extending loans or credit to board members and senior managers. Sarbanes-Oxley specifically addresses this issue and makes it unlawful for a public company to provide direct or indirect loans or credit to board members or senior managers.

- Review your corporate compliance program to ensure that it addresses
the organization’s business conduct policy and commitment to honest, ethical behavior.

Establish an Audit Committee of the Board

Sarbanes-Oxley raises the bar on management’s responsibility to ensure that the audit processes and financial reports/statements of the organization are true and accurate. It also contains specific provisions that address auditor conduct and independence, adherence to generally accepted accounting principles, and limitations on the types of non-audit services that can be provided by the same auditor.

The Act requires public companies to establish an internal audit committee of the board to oversee the appointment, compensation, and auditing processes of the company. It requires that at least one member have expertise in financial matters. The audit committee must also develop a process for responding to any complaints or concerns about questionable auditing practices, as well as a mechanism for reviewing any verbal directions or written statements between senior management and the auditor that may have material implications in interpreting the final report or financial statement. The committee is expected to meet regularly with internal and external auditors to stay informed about these issues.\(^4\)

Sarbanes-Oxley also requires that public company executives review and certify each annual or quarterly financial report. The certification is intended to attest to the validity of the information and that its representations are truthful and accurate to the best of their knowledge. Any officer who knowingly provides false certification statements is subject to criminal penalties, including the forfeiture of any bonus or incentive pay earned in the year prior to the statement. Thus, it is critical that the organization develops internal controls for monitoring the validity of the audit process, and the quality and accuracy of the audit data, as well as encourages the reporting of known or suspected violations.

Note that the audit committee’s responsibilities are very different from those of the typical not-for-profit finance committee, which is concerned with raising and appropriating capital for organizational improvement or the resolution of debt.

In the not-for-profit world, the establishment of an independent audit committee may be the greatest challenge for rural and community-based hospitals. Often, the local talent pool is limited, and finding qualified
volunteers who have the time to devote to fulfilling the responsibilities of this committee can be difficult. Still, the intentions of the Act, insofar as setting the standard for corporate responsibility for the integrity of the audit process, should not be dismissed. The consequences of a board’s overreliance on flawed financial and audit reports can devastate the organization’s reputation and jeopardize its existence. Imagine, for example, all of the various regulatory and accreditation bodies that would likely respond to a media account of a hospital or health care system’s conviction of fraudulent accounting practices. The health care organization could easily lose its license, be subject to additional investigations and fines, jeopardize the flow of grant funds, forfeit its accreditation status, and face exclusion from the Medicare program. So, given the limited resources, how do small and rural hospital executives and trustees incorporate this greater goal of accounting responsibility? The answer may lie in the provisions of the statute that speak to the responsibilities and duties of public accounting firms and auditors.

Auditors and Public Accounting Firms

Sarbanes-Oxley establishes a Public Company Accounting Oversight Board (PCAOB), under the auspices of the Securities Exchange Commission (SEC), to oversee the audit practices of public companies. The PCAOB has the authority to promulgate standards relating to assuring the integrity of the company’s auditing process and the accuracy of its final audit report. All U.S. and foreign-based public accounting firms are required to be registered with the PCAOB. Public accounting firms that fail to register are barred from participating in the preparation or issuance of any audit report.\(^5\) The PCAOB requires each public accounting firm to complete an initial application and submit periodic reports. Both of these reports are available to the public and are valuable sources of information to those who are negotiating contracts with accounting firms. The reports contain an itemization of the firm’s current and former clients, the names of all accountants who work for the firm, an explanation of its quality control practices, and disclosure of any information related to its involvement in criminal, civil, or adverse administrative actions.

Public accounting firms that violate statutes can incur serious penalties, including temporary suspension or permanent revocation of their registration status with the PCAOB, civil monetary penalties, and sanctions.

Sarbanes-Oxley prohibits an auditor from a registered public accounting firm from performing audit services and non-audit services at the same time.
The Act seeks to preserve the auditor’s independent judgment as it relates to audit activity. It specifically forbids the performance of other non-audit services, citing examples such as bookkeeping, developing accounting records or financial statements, developing and maintaining internal financial information systems, actuarial services, management functions, investment advising, banking services, legal services, or any other expert services unrelated to the audit. The law makes certain limited exceptions (e.g., tax preparation) to this broad prohibition, but these must be reviewed and preapproved by the PCAOB.

In other efforts to preserve an auditor’s independence and increase investor confidence, the Act imposes a limit of five years on how long a public accounting firm can audit a particular organization, and it also requires that the primary auditor’s report be reviewed by a second auditor who is able to concur with the results.

To further minimize any potential conflicts of interest, Sarbanes-Oxley prohibits a public accounting firm from providing audit services to a public company if the CEO, controller, CFO, or any other similar executive was employed by the accounting firm and participated in an audit of that company the year preceding the date of the initiation of the audit. This has obvious implications for the need for due diligence in verifying prior employment of senior managers.

The rural or community hospital that lacks sufficient local qualified financial experts to monitor its accounting program can use accounting firms that are required to comply with the Act, thereby increasing confidence that the accounting firm is in compliance with the law and is reputable in its accounting practices. It should be emphasized that board members and senior managers must not ignore their obligations for the ultimate oversight of the accounting program and certification of the financial reports. At Chubb, we encourage a greater participation by not-for-profit organizations in the spirit of the law, even when there may be some limitations on their ability to comply. Following are suggestions for selecting an audit firm and strengthening your organization’s efforts to incorporate the Sarbanes-Oxley provisions into its financial operations:

- Exercise due diligence when selecting a public accounting firm.
- Confirm that your public accounting firm is registered with the PCAOB. To check, go to www.pcaobus.org.
Examine the PCAOB application and the firm’s annual report for a list of its former and existing clients. Look for a statement about the firm’s quality control practices, a list of its employed accountants, and disclosure of any information related to criminal, civil, or disciplinary actions pending with the firm.

Obtain references from former or current clients of the firm.

Find out if the accounting firm has experience auditing health care and not-for-profit organizations.

Determine if the firm is familiar with the vast array of regulatory obligations imposed on hospitals and health care providers (examples: HIPAA, CMS, state licensure, IRS code, JCAHO, or AOA standards).

Make sure the firm adheres to generally accepted accounting and auditing standards and affirms that it will abide by professional standards of accounting principles.

The firm should be a member of The American Institute of Certified Public Accountants (or other professional society).

The firm should carry sufficient accountant liability insurance.

Make sure your contract with the firm includes a hold harmless provision.

The firm should sign a confidentiality agreement to comply with HIPAA regulations.

Review and revise your contract with the audit firm to ensure that the audit services performed are not so broad that they provide an opportunity for the auditor to lose its objectivity, thereby compromising the integrity of the audit report. If the auditor is providing any other non-audit services or expert advice unrelated to the audit report to your organization, then the auditor may have difficulty maintaining its objectivity.

Ensure that top executives and board members have had no prior employment or recent audit relationship that could pose a conflict of interest. Have each executive and board member review and sign a conflict-of-interest statement on an annual basis.

Make sure that the accounting firm can provide a peer review and quality control standards.
The firm should provide for a concurring or second partner review and approval of any audit reports.

The accounting firm should provide for the safe retention of auditing records related to any audit report (five years required).

Maintain internal controls to ensure that material information relating to financial reporting procedures, stability of the organization, or fraud is made available to the officers and auditor.

1 You can download a complete copy of the Act at www.pcaobus.org.
2 Reed, J. Healthcare Trustees of New York State, A Special Report, Sarbanes-Oxley: Implications for Governing Board Members of New York State’s Not-for-Profit Health Care Provider Institutions, August 2003.
5 A number of professional accounting organizations are working with the PCAOB to develop best practices and standards for accounting practices. For additional resources, visit the American Institute of Certified Public Accountants at www.aicpa.org.
Health Care Not-for-Profits Under the IRS Looking Glass: Lessons for Tax-Exempt Entities

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Not-for-profit health care organizations qualifying for tax-exempt status under Internal Revenue Code (IRC) 501(c)(3) enjoy significant tax benefits compared to their for-profit counterparts. While Congress questions whether not-for-profit organizations should continue to enjoy tax-exempt status, the IRS has become more sophisticated in its understanding and handling of health care organizations. The message from Washington is clear: No health care organization should take its tax-exempt status for granted. Now more than ever, organizations need to pay careful attention to obtain and to retain their 501(c)(3) status and to avoid those activities that could potentially jeopardize their tax-exempt status. The failure to heed these concerns could be devastating for health care organizations and their boards of directors.

The Benefits of 501(c)(3) Status for Not-for-Profit Health Care Organizations

Qualifying organizations generally enjoy many benefits from 501(c)(3) status, including exemptions from:

- Federal (and in most cases state) income taxes.
- Federal and most state property and sales taxes.
- Federal unemployment taxes.

Beyond these exemptions, 501(c)(3) entities enjoy the ability to finance with tax-exempt bonds, as well as to offer tax deductibility to donors for any donations made to the tax-exempt organization. Savings realized from the allowable avoidance of federal and state income and/or property taxes can translate, for many organizations, into millions of dollars annually.

How Not-for-Profit Health Care Organizations Qualify for 501(c)(3) Status

An organization can qualify for tax-exempt status under 501(c)(3) either by itself or by showing that its activities are an “integral part” of the exempt activities of another 501(c)(3) organization. In seeking 501(c)(3) status, an organization first needs to file an exemption application (Internal Revenue
Service (IRS) Form 1023) with the IRS, providing extensive information on its past, current, and future business activities. These activities must further a charitable, religious, educational, or scientific purpose. To that end, and with respect to the mission of health care organizations in general, the IRS has determined in Revenue Ruling 69-545 that the “promotion of health” qualifies as a charitable purpose.\(^2\) Additionally, Revenue Ruling 69-545 establishes the “community benefit” standard for determining whether an organization may qualify for the 501(c)(3) exemption. In this regard, the amount of charity care that an organization provides annually may be illustrative of the amount of community benefit derived from the organization’s charitable purpose of providing health care to the indigent poor. Under Revenue Ruling 69-545, the “community benefit” standard requires that an organization have an emergency room open to the general public, without regard to ability to pay and that health care services be provided to non-emergency patients regardless of their ability to pay (including Medicare and Medicaid patients). Also under the “community benefit” standard, a majority (greater than 50 percent) of the board of directors for the organization should be independent, representative members of the local community, who do not have any financial conflict with the organization.\(^3\)

IRC 501(c)(3) provides for both an organizational test and an operational test with respect to organizations applying for exempt status. The organizational test requires that an entity exist solely to fulfill one or more exempt purposes and that it be structured as a corporation, association, trust and, if properly structured, a limited liability company. The organization’s articles of incorporation must also expressly state that the organization’s purpose is limited to one or more exempt purposes.\(^4\)

Under the operational test requirement, the organization must engage “primarily” in activities that support its exempt purpose(s), and if it engages in any types of activities that are not so supportive, it must be able to defend to the IRS that such activities are only “incidental” to the principal, exempt purpose(s) of the organization. The operational test under 501(c)(3) is not satisfied if either significant private benefit or “insider” benefit (inurement) results from any activity or transaction. The IRS absolutely prohibits any personal, private benefit or gain from any activity or transaction by organization “insiders” (i.e., directors, officers, board members, key employees). Exempt organizations might consider paying and receiving fair market value both for services provided and received, as well as property
bought and sold, in an effort to avoid the private benefit/inurement quagmire and the potential resulting revocation of tax-exempt status.

**Potential Jeopardy to 501(c)(3) Status**

Several actions can jeopardize a tax-exempt health care organization’s exempt status. Inappropriate activities involving executive compensation practices, political activities, and lobbying are of concern. For example, a questionable practice involves compensation paid to a hospital CEO that is far greater than that paid by similar health care organizations. Deviating substantially from acceptable compensation practices could subject an organization to potential loss of its tax-exempt status and expose the board of directors to potential liability with respect to their duties of diligence and loyalty in directing organization revenue.

The IRS has also mandated certain restrictions on a tax-exempt organization’s involvement in lobbying and political activities. Some latitude is allowed for lobbying activities, but 501(c)(3) states that no “substantial” part of an organization’s activities can involve attempts to influence legislation. Conversely, with respect to political activities, an organization is absolutely prohibited from participating in any way in a political campaign either for or against a candidate. Some activities are allowed but, in general, the prohibition as outlined above is so strong that organizations would be wise to carefully scrutinize any situations in which employees are participating in political activities.

**IRS Sanctions for Unacceptable Practices**

Revocation of tax-exempt status is the most severe penalty for engaging in prohibited activities. In lieu of revoking tax-exempt status, however, the IRS may impose lesser sanctions in the form of tax penalties on (1) “insiders” who profit from transactions with exempt organizations and (2) the exempt organization’s directors and officers who knowingly participated in such transactions. Penalties can be steep, and they can increase up to 200% of the profit/benefit that was improperly obtained if the transaction is not corrected in the time period specified by the IRS.5

**The IRS on Joint Ventures in the Health Care Industry**

With respect to joint ventures, IRC 501(c)(3) provides for a two-part “close scrutiny test” to satisfy the operational test requirement for exempt status. Specifically, 501(c)(3) provides that an exempt organization can participate in a partnership (i.e., joint venture) with a non-exempt organization as long
as the terms of the partnership agreement allow the exempt organization to continue to further its exempt purpose(s) and to act, only *incidentally*, for the benefit of the non-exempt (for-profit) partner/entity. In that regard, guidance from the IRS in Revenue Ruling 98-15 supports the close scrutiny test in which the exempt organization transfers all of its assets to the non-exempt/for-profit partner entity.

The IRS has provided guidance for joint ventures wherein such activities comprise only an insignificant portion of the exempt organization’s activities. This guidance focuses on the amount of control that the not-for-profit entity must have over the joint venture/arrangement in order to satisfy the operational test under IRC 501(c)(3) and to avoid jeopardizing an organization’s tax-exempt status. The key point is that the exempt entity must exercise enough control over the venture’s activities such that the charitable purpose of the exempt organization is not compromised.

**Conclusion: Avoiding Jeopardy to Tax-Exempt Status**

Congress and the IRS will continue to scrutinize 501(c)(3) tax-exemption status for health care organizations and may tighten rules to limit the tax exemption long afforded not-for-profit health care. In a climate of increased legislative and regulatory attention, vigilance is essential for tax-exempt health care organizations.

The mission and vision of the tax-exempt organization are the guiding principles for compliant tax-exempt health care organizations. The board of directors must set a tone that nothing less than strict adherence with IRS rules and guidance is expected for the tax-exempt health care entity. Appropriate advice should be obtained before engaging in activities that could test the 501(c)(3) status of the health care organization.

At the management level, sound business risk management principles can help maintain the integrity of the entity’s tax-exempt status. Aside from education, guiding documents are important with respect to prudent business practices. Maintaining the organization’s tax-exempt status requires proper actions by everyone, from the CFO to the marketing, contracting, and purchasing departments. Should any inconsistent practice become apparent, prompt intervention is necessary to rectify what could threaten the entity’s tax-exempt status. Good auditing and documentation practices are essential in order to substantiate compliance with regulatory requirements.

Rather than looking at IRS rules and guidance as hindrances, the opposite perspective should be embraced. The IRS documents serve as a blueprint for
tax-exempt organizations. By aligning the mission, vision, and strategic plan of the tax-exempt organization with 501(c)(3) requirements, solid business decisions can be made and implemented for the delivery of patient care even in an atmosphere supercharged with rigorous scrutiny of tax-exempt health care organizations.

1 See Treasury Reg. 1.502-1(b); Geisinger Health Plan v. Commissioner, 100 TC 394 (1993), aff’d 30 E3d 494 (3rd Cir. 1994).

2 See Revenue Ruling 69-545.

3 The IRS requirement that no board member have any financial conflict with the organization does not necessarily take into account the possibility that indiscriminate application of this standard by an organization, especially in a conflict-credentialing context, could potentially result in the loss of state peer review privilege/immunity if the decision to remove credentials rests solely on a financial-conflict basis without any requisite quality-of-care nexus.

4 IRC 501(c)(3); Treas. Reg. 1.501(c)(3)-1(b).

5 IRC sec. 4958; Treas. Reg. 53.4958.
Trends in Health Care Governance

By Eric D. Lister, M.D.
Principal, Ki Associates and HealthSure Consultants
Co-Director, The Healthcare Trustee Institute

Well-publicized problems with governance in the for-profit world have had a spillover effect in the not-for-profit health care industry. Concerns about possible conflicts of interest and lack of good stewardship practices have generated changes.

Broader Understanding of Fiduciary Responsibility

Although most health care organization trustees understand their fundamental duties—the duties of care, loyalty, and mission—they are becoming increasingly aware of the need to focus on these fundamental principles. Trustees are now focusing more on community health, medical staff oversight, and the need to balance that oversight with a spirit of partnership. Achieving a better understanding of this burgeoning fiduciary responsibility requires trustees to carefully consider several factors, including:

- In the context of strategic planning, does the board review community health statistics?
- Does the board regularly partner with community agencies?
- Is there regular interaction between the board and physician leadership?
- Has the board articulated principles and policies to govern medical staff credentialing?

More Rigorous and Transparent Oversight of Financials

Most provisions of the Public Company Accounting Reform and Investor Protection Act of 2002 (Sarbanes-Oxley Act), enacted in the aftermath of well-publicized financial improprieties in the for-profit world, do not apply to not-for-profit organizations. However, criminal provisions concerning obstruction of justice via document destruction and retaliation against whistleblowers apply to private corporations and not-for-profit organizations.1 Sarbanes-Oxley also indirectly prohibits public accounting firms, which provide financial auditing services to any organization regardless of its tax status, from providing additional services to the same organization.
Additionally, many states, including New York, are considering legislation that will impose the key elements of Sarbanes-Oxley much more broadly. Across the United States, governance experts are encouraging hospital boards to act proactively and to improve the transparency and rigor of their oversight activities.

Designing a rigorous transparent oversight of financials requires consideration of several factors, including:

- Does your organization’s board have an audit committee separate from the finance committee?
- If so, is this committee composed solely of outside directors?
- Does the board routinely excuse the CEO from meetings to allow non-executive directors to have candid conversations about “how things are going”?
- Does the board reach out to the community regularly and actively to provide information on the hospital and seek input?

**Heightened Attention to Issues of Quality and Safety**

The Joint Commission on Accreditation of Healthcare Organizations (JCAHO) has made it clear that hospital boards are responsible for overseeing clinical quality. Rising public concern about the safety of the health care system and quality improvement regulations promulgated in January 2003 have pushed this responsibility to the forefront of board agendas everywhere. Although many boards have moved proactively to develop the skills necessary to rise to this challenge, many well-intentioned trustees are simply overwhelmed by the task. The answers to several questions can help guide board oversight of quality and patient safety, including the following:

- Does the board have a separate committee charged with overseeing issues of quality and safety?
- Does this committee integrate data from an enterprise-wide approach to risk management?
- Has the board created an institutional imperative to institute the 30 critical safe practices endorsed by the National Quality Forum (www.qualityforum.org), a group of organizations that have a shared vision of quality patient care?
Is compliance with those practices regularly tracked?

Does the board track the hospital’s clinical outcomes on key measures across time and compare its results with similar institutions?

Has the board implemented provider scorecards?

Have trustees sought education specifically related to their responsibilities in the quality and patient safety arenas?

Conclusion: More Change Is Expected

Governance is an evolving concept in the health care field. The degree of responsibility is expected to increase as trustees pay more attention to fiduciary, financial, and quality-of-care factors. To the extent that patient safety becomes a focal point of state and federal regulation, the trend of increased responsibility and accountability of hospital boards is expected to continue. Governance education and best practices will be essential in meeting these responsibilities.

# Proactive Governance Checklist

This self-assessment checklist is provided as a courtesy to Chubb Health Care customers to help provide practical risk management strategies for the boards of directors of not-for-profit health care entities.

## Mission, Vision, and Strategic Plan

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
<th>N/A</th>
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</thead>
<tbody>
<tr>
<td>1.</td>
<td>Do the organization’s mission and value statements articulate a commitment to and guide for fiscally responsible and ethically sound business practices in the provision of health care services?</td>
<td></td>
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<tr>
<td>2.</td>
<td>Is the strategic plan aligned with the mission and value statement of the health care organization?</td>
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<tr>
<td></td>
<td>In the context of strategic planning, does the board review community health statistics?</td>
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<td></td>
<td>Does the board regularly partner with community agencies?</td>
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<td>Does the board reach out to the community regularly and actively to provide information on the hospital and seek input?</td>
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<td></td>
<td>Are the organization’s overall business activities congruent with the strategic plan, mission, and value statement to ensure that the entity continues to meet its core tax-exempt purpose?</td>
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<td></td>
<td>Is the organization fulfilling an obligation to provide care to the indigent poor?</td>
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<tr>
<td></td>
<td>Have recent acquisitions/mergers, partnerships, or joint venture agreements compromised the organization’s tax-exempt purpose?</td>
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<td>3.</td>
<td>Has the board developed key performance indicators to assess the leadership’s progress toward achieving the organization’s strategic plan?</td>
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<td></td>
<td>Are these reviewed on an annual basis?</td>
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</table>

## Organizational Bylaws

## Business Conduct and No Conflict of Interest

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
<th>N/A</th>
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</thead>
<tbody>
<tr>
<td>1.</td>
<td>Do the bylaws provide for the independent status of board members, free of any actual or potential conflicts of interest?</td>
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<td>2.</td>
<td>Do the bylaws articulate a process for directors to provide full disclosure of any potential conflict of interest to the board?</td>
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<td></td>
<td>If, after full disclosure, the board elects to pursue the activity, do the bylaws articulate that the director with the potential conflict remove himself/herself from any further discussion and refrain from voting on the matter?</td>
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</table>
3. Do the organization’s bylaws prohibit directors, officers, board members, and key employees from inuring any personal benefit or gain from activities or transactions made on behalf of the organization?

☐ Yes ☐ No ☐ N/A

☐ Yes ☐ No ☐ N/A  ■ Does this statement include a prohibition on the acceptance of gifts or favors that might adversely influence a director’s decision making or actions to the detriment of the organization?

☐ Yes ☐ No ☐ N/A  ■ Does this statement incorporate a requirement that prohibits board members from using the assets of the not-for-profit health care organization for personal gain or to receive direct or indirect loans or credits from the organization?

☐ Yes ☐ No ☐ N/A  4. Does each director review and sign a “Code of Conduct and Resolution of Conflicts of Interest” statement on an annual basis?

☐ Yes ☐ No ☐ N/A  5. Is the corporate compliance program aligned with the organization’s policies on conflicts of interest, confidentiality, and sound business practices?

☐ Yes ☐ No ☐ N/A  6. Do the bylaws set clear expectations for regular trustee attendance at board and committee meetings?

☐ Yes ☐ No ☐ N/A  7. Do the bylaws include a provision that requires board members to act in the best interests of the not-for-profit health care organization and to respect the board’s confidentiality requirements?

☐ Yes ☐ No ☐ N/A  8. Do the bylaws articulate the responsibility for providing safe, quality medical care to the medical staff including:

☐ Yes ☐ No ☐ N/A  ■ Regular interaction between the board and physician leadership?

☐ Yes ☐ No ☐ N/A  ■ Principles and policies to govern medical staff credentialing?

**Tax-Exempt Status**

☐ Yes ☐ No ☐ N/A  1. Have the bylaws had a legal review performed to assess their adherence to IRS rules for tax-exempt health care entities?

☐ Yes ☐ No ☐ N/A  2. Do the bylaws provide for a due-diligence process with regard to properties purchased or sold at fair market value to avoid the prohibited “private benefit” and the potential revocation of tax-exempt status?

☐ Yes ☐ No ☐ N/A  3. Do the bylaws define “appropriate activity” with regard to political activities and lobbying?
BOARD COMPOSITION, STRUCTURE, AND FUNCTION

1. Is the size of the board limited to fewer than 20 members to promote efficiency?
   - Yes
   - No
   - N/A

2. Are at least half of the trustees independent, representative members of the local community?
   - Yes
   - No
   - N/A

3. Is there an adequate skill set among board members, including attributes such as:
   - The ability to exercise independent judgment?
   - Integrity?
   - The ability to work as part of a team?
   - Sufficient time and interest to devote to the job?
   - Commitment to acting in the best interests of the corporation?
   - Expertise in legal, health care, and financial knowledge?
   - Ability to interpret and monitor the financial reports of the health care organization?
   - Good understanding of generally accepted accounting principles used in not-for-profit health care organizations?

4. Is a process in place to credential individuals who serve on the board of directors?
   - Yes
   - No
   - N/A

5. Does this process include a criminal background check?
   - Yes
   - No
   - N/A

6. Do the bylaws limit individual board member terms to ensure fresh ideas, a renewed scrutiny, and energy to the job?
   - Yes
   - No
   - N/A

7. Do the renewal terms discourage consecutive terms without requiring each member to relinquish his/her position for a period of time before beginning a new term?
   - Yes
   - No
   - N/A

8. Is there a limit on the number of consecutive terms a trustee may serve in order to discourage long-term associations that could lead to possible abuse of power?
   - Yes
   - No
   - N/A

9. Are the trustee terms rotated so that less than one-third of the board is new to their position at any one time?
   - Yes
   - No
   - N/A

10. Does the board periodically review its committee structure to avoid overlapping responsibilities and streamline the approval process?
    - Yes
    - No
    - N/A

11. Is the need for each committee re-evaluated on an annual basis?
    - Yes
    - No
    - N/A

12. Has the board evaluated the adequacy of the organization’s D&O liability insurance coverage for trustees?
    - Yes
    - No
    - N/A
Did this review examine the adequacy of the indemnification clause to ensure that each trustee is protected (to the extent possible) from any personal liability for his/her properly performed duties?

8. Does the board have an audit committee that is separate from the finance committee?

Is the audit committee composed solely of outside directors?

Does the audit committee regularly apprise the board of the financial status of the health care organization?

Has the board established an internal audit process and oversight committee that includes the use of an appropriately accredited accounting firm?

9. Are the trustees provided with all management materials, reports, and committee meeting minutes for their review well in advance of board meetings?

COMPENSATION AND EVALUATION OF LEADERSHIP

1. Are executive salaries (or any board member compensation) substantiated by a fair market value analysis to avoid the potential revocation of tax-exempt status?

2. Is there a procedure for excusing the CEO from meetings to allow non-executive directors to have candid conversations about “how things are going”?

3. Is leadership performance monitored and evaluated at least annually?

BOARD EDUCATION AND RESPONSIBILITIES

1. Do new board members receive a formalized orientation to their responsibilities?

2. Is there a process in place for all trustees to attend ongoing education programs on:

- Key health care issues and laws that impact the not-for-profit industry?
- Understanding compliance with regulatory issues, accreditation guidelines, and local ordinances?
- Trustee fiduciary duties and the potential for financial loss from D&O liability claims?
<table>
<thead>
<tr>
<th>Question</th>
<th>Yes □ No □ N/A</th>
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<tbody>
<tr>
<td>The IRS code and regulations as they apply to 501(c)(3) organizations?</td>
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<tr>
<td>The need to avoid inappropriate involvement with political and lobbying activities?</td>
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<td>Understanding the financial reports and generally accepted accounting principles?</td>
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<td>Understanding the organization’s liability, risk retention, and risk transfer, including insurance program and risk management activities?</td>
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<td>The resolution of patient grievances?</td>
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<td>Overseeing the condition and effectiveness of the corporate compliance program?</td>
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<td>Credentialing of health care providers?</td>
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<td>Medical staff appointments?</td>
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<td>Peer review process and protections?</td>
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<tr>
<td>Antitrust laws and restraint-of-trade issues?</td>
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<td>Employment laws?</td>
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<tr>
<td>Fraudulent billing practices?</td>
<td>□</td>
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<tr>
<td>Clinical research activities?</td>
<td>□</td>
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<tr>
<td>Restrictions on professional advertising?</td>
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<tr>
<td>Marketing issues in health care?</td>
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<td>Overseeing patient safety and quality improvement programs?</td>
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<tr>
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<td>□</td>
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</tbody>
</table>
☐ Yes ☐ No ☐ N/A - Have trustees sought education specifically related to their responsibilities in the quality and patient safety arenas?

☐ Yes ☐ No ☐ N/A - Does the board have a policy for disclosure of unanticipated outcomes and sentinel events?

**DOCUMENTATION**

☐ Yes ☐ No ☐ N/A 1. Do the bylaws articulate the procedure for recording board actions and meeting minutes?

☐ Yes ☐ No ☐ N/A 2. Do board meeting minutes reflect an accurate recording of all board actions and/or deliberate inactions, including the rationale for decisions?

☐ Yes ☐ No ☐ N/A 3. Are documents reviewed in connection with a board decision attached to the minutes?

☐ Yes ☐ No ☐ N/A 4. Is a tally of each vote, along with any dissent, recorded?

☐ Yes ☐ No ☐ N/A 5. Is there a policy to address the need to retain board documents indefinitely?

**ANNUAL REVIEW AND EVALUATION**

☐ Yes ☐ No ☐ N/A 1. Does the board conduct an annual self-assessment of its performance and of the performances of individual board members and key executives?

☐ Yes ☐ No ☐ N/A 2. Does the board conduct an annual self-assessment to assess its progress at achieving its mission and overall strategic plan?

☐ Yes ☐ No ☐ N/A 3. Does this review incorporate data such as trustee attendance at board and committee meetings?
This guide is advisory in nature. It is offered as a resource to be used together with your professional insurance and legal advisors in developing a loss control program. This guide is necessarily general in content and intended to serve as an overview of certain aspects of employment law in the United States. It should not be relied upon as legal advice or a definitive statement of law in any jurisdiction. For such advice an applicant, insured or other reader should consult their own legal counsel. No liability is assumed by reason of the information this document contains.

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