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Advising Health Care Boards on Achieving Fiduciary "Effectiveness"

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Constituents, regulators, and observers of corporate governance are increasingly focused on the "effectiveness" of board performance: the extent to which its existing governance practices and orientation are consistent with (or exceed) industry standards and recognized principles. This is especially the case in an industry as diverse and challenging as health care, where governance conduct is continuously being pressured by events and perceptions.

Because "effectiveness" measurements directly impact the law of fiduciary duty and relate to third-party concerns with legal standards of director conduct, the organization's chief legal officer is well positioned to advise the leadership team in connection with "effectiveness" measures.

Emerging Concerns with "Effectiveness"

The current focus on director effectiveness is a byproduct of at least four ongoing governance conversations. First is the increasing value placed on director evaluations as a refreshment mechanism; linking individual director performance with effectiveness standards and the nomination/renomination process. Individual board member assessments are critical to ensure that members are effectively contributing to board work and continually developing their skills, as well as enabling the board to apply reappointment criteria, yet many boards do not participate in this practice. According to The Governance Institute's 2021 biennial survey, only 31% of hospital and health system boards reported that they use a formal process to evaluate the performance of individual board members.[1] To the extent that this process increases board turnover, it is believed to create more opportunities for diverse board nominees.

Second are the strong indications that more than ever before, the law expects corporate directors to engage in the vigorous and informed oversight of the business. A passive approach to governance responsibilities will be viewed with scrutiny and enhanced board engagement.

Third are the evolving third-party expectations of corporate directors' oversight obligations—that directors must be attentive to a larger universe of issues than before. Responding to these expectations will impact how directors perform their duty of care in the future (thus implicating effectiveness issues). Directors are already on notice of changing expectations regarding this duty. A series of important Delaware decisions over the last three years (e.g., *Marchand* and its progeny) have emphasized the board's obligation to exercise close, formal oversight of what they determine to be the "mission-critical risks" of the organization. The failure to do so can have significant implications for the board's risk profile.

Fourth is the suggestion that director performance may not be matching CEO expectations. A notable finding from the most recent PwC annual Board Effectiveness survey is that "executives rate overall director performance as lackluster."[2] According to PwC's analysis, most surveyed executives say directors are doing a "fair" job (55%), with a surprisingly small percentage grading them as "excellent" (10%) or "good" (19%).

Core Indices of Board Effectiveness

It is within this context that the board may wish to consider comparing its current practices against established indices of director effectiveness and consider such enhancements as may be appropriate. Those indices include the following:

- **Director engagement**: The overarching commitment of the director to meet the highest possible level of performance, including but not limited to matters of preparation, meeting attendance, awareness of key business risks and opportunities, familiarity with corporate strategic direction, understanding of the company's industry sector, and recognition of its constituent base.
- **Board composition**: Factors such as director independence, ethics/integrity, competence and experience, and acceptance of diversity, equity, and inclusion across multiple dimensions.
- **Board refreshment**: Board policies designed to ensure appropriate board turnover, including such measures as independence requirements, term limits, age limitations/retirement requirements, diversity commitments, skill and competency standards, evaluation practices (see below), adjustments in board and committee size, "fitness to serve" qualifications, change in status conditions, succession, and "offboarding" measures. Boards vary in adopting these practices. For example, according to The Governance Institute's biennial survey, 64% of hospital and health system boards limit the number of consecutive terms, but only 5% have age limits.[3]
- **Evaluation protocols**: The expectation is that the board should have a robust process to evaluate itself and its committees on a regular basis, led by the non-executive chair, lead independent director, or appropriate committee chair. The process should include both individual director self-evaluation and full board evaluation. Hand-in-hand with this is the fortitude of the board to replace ineffective directors. (Note in this regard, the Board Effectiveness survey mentioned above found that 55% of responding CEOs rated overall director performance as "lackluster".)
- **"Constructive skepticism"**: This is a boardroom characteristic in which directors are encouraged to present to management incisive, probing questions regarding key decision making and oversight issues, with the expectation that they will receive accurate, forthright answers to those questions. It is "constructive" in the sense that the questions are presented in a respectful manner. It is "skeptical" in that directors are not required to accept all answers at "face value" but to pursue further data as may be indicated.
- **Intra-board culture**: The preservation of collegial relationships amongst members of the board, as well as between board members and the senior leadership team; an arrangement that in both cases is intended to facilitate full and frank dialogue.

- **Internal reporting mechanisms**: As emphasized by recent Delaware law decisions, this relates to the maintenance of management-to-board reporting systems on "mission-critical risks," so that the board is well positioned to respond to such risks.
- **Corporate, board, and committee structure**: The practice of the board to periodically re-evaluate how the corporation and its board/committee arrangements are structured in a manner sufficient to support effective governance and satisfaction of fiduciary responsibilities. This should occur at least every three to five years.
- **Board education protocols**: The mechanism by which the board is continually educated on the company, its industry, and events that have an impact on both. This would include delivery of information from a variety of appropriate sources, including research reports, audit reports, and where relevant, legislative and regulatory developments. The board should be free to access outside experts and advisors to participate in the information and education messaging. The Governance Institute's survey showed that 33% of respondents spend $30,000 or more annually for board education, a threshold that has been shown to positively impact board culture and performance (a rising trend from 27% in 2017).[4]

The periodic, good faith evaluation by the governing board of its practices as compared to these and other indices of director effectiveness will be an effective prophylactic against board liability and will support the satisfaction of director duties. We believe the chief legal officer should be an integral part of this board effectiveness process, both because of its relationship to fiduciary duties and other legal criteria, and because this process will benefit from the involvement of the chief legal officer as a trusted advisor to the board.

About the Authors

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Primary Sources: Commonsense Principles of Corporate Governance 2.0; The Business Roundtable, *Principles of Corporate Governance*; Internal Revenue Service, "Life Cycle of a Public Charity-Governance"; Martin Lipton, "Spotlight on Boards," Harvard Law School Forum on Corporate Governance, September 2, 2021; Independent Sector, *Principles for Good Governance and Ethical Practice*.

Endnotes

[1] Kathryn Peisert and Kayla Wagner, *Advancing Governance for a New Future of Healthcare*, The Governance Institute's 2021 Biennial Survey of Hospitals and Healthcare Systems.

[2] *Board Effectiveness: A Survey of the C-Suite*, PwC and The Conference Board, November 2021.

[3] Peisert and Wagner, 2021.

[4] Peisert and Wagner, 2021.