FAIR POLITICAL PRACTICES COMMISSION

P.O. Box 807 • 428 J Street • Sacramento, CA 95812-0807
(916) 322-5660 • Fax (916) 322-0886

April 20, 2001

Colin J. Coffey
Archer-Norris
Post Office Box 8035
Walnut Creek, CA 94596-3728

Re: Your Request for Advice
Our File No. A-01-064

Dear Mr. Coffey:

This letter is in response to your request for advice on behalf of Director Tarilyn Hanko regarding the conflict of interest provisions of the Political Reform Act (the "Act").[1]

QUESTION

May Director Hanko participate in the discussions and vote on matters pertaining to the decision regarding the proposed "restructured relationship" between the District, MPHS and Sutter?

CONCLUSION

No. Director Hanko has an economic interest in MPHS, and it is reasonably foreseeable that the decision regarding the proposed "restructured relationship" between it, the District and Sutter will have a material financial effect on MPHS. Therefore, she may not participate in the discussions or the decision.

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[1] Government Code sections 81000 – 91014. Commission regulations appear at Title 2, sections 18109-18996, of the California Code of Regulations.

The Peninsula Health Care District ("District") is a local health care district organized under the provisions of the California Health and Safety Code §§ 32000 *et seq.* For more than a year, the District has been negotiating a contractual "restructured relationship" with Mills Peninsula Health System ("MPHS"), a wholly owned subsidiary (as that term might apply in the non-profit sector) of Sutter Health ("Sutter"). Both MPHS and Sutter are California non-profit public benefit corporations. MPHS is a local entity operating the San Mateo health system, which consists of the merged operations of Peninsula Hospital and Mills Hospital. Sutter is a large multi-hospital system. MPHS affiliated with Sutter in January 1996.

In 1985, the District entered into a 30-year lease of its hospital, Peninsula Hospital in Burlingame (the "Hospital"), with MPHS, pursuant to which MPHS operated the Hospital and the District became the landlord. In 1997, the District commenced litigation against MPHS, seeking to invalidate the Lease based on circumstances underlying the negotiation and execution of the Lease. In 1998, while the litigation was pending, seismic safety regulations were issued by the state implementing SB 1953, legislation enacted in 1995, mandating earthquake structural integrity standards for California hospitals. After each conducted independent engineering studies, both the District and MPHS concluded that the Hospital would need to be replaced with a newly constructed facility. Recent amendments to the original legislation mandates replacement of the facility by the year 2013. The District and MPHS then began to negotiate a resolution of the issues created by SB 1953 and the lawsuit.

The negotiations between the District and MPHS were aimed toward a global settlement of the litigation by which MPHS (assisted with financing from Sutter) would construct and operate a new hospital on land leased from the District, subject to terms guaranteeing specified community benefits and granting the District certain oversight responsibilities. In August of 2000, the District, MPHS, and Sutter approved a Letter of Intent incorporating preliminary terms of a global settlement, including dismissal of the District's lawsuit. The District and MPHS are currently negotiating what would be final contractual terms of the "restructured relationship." If the District, MPHS, and Sutter reach final contractual terms, the terms of the "restructured relationship" will be placed on an upcoming ballot for approval or disapproval by voters residing in the District.

Director Hanko was elected to the District Board for the first time last November. Director Hanko is employed by Baxter Healthcare Corporation, a Fortune 500 company conducting business worldwide in pharmaceutical and healthcare supplies. She also owns stock that has a value in excess of $2,000. The District itself has no relationship with Baxter. MPHS, however, purchases Baxter products. During calendar year 2000, Baxter sales to MPHS, including Peninsula and Mills hospitals (Mills is an outpatient services facility) amounted to approximately $387,400.

Director Hanko is a "Pharmaceutical Products Specialist" for Baxter. Her duties consist mainly of marketing certain Baxter pharmaceutical products to healthcare providers, including hospitals, long term care providers, surgery centers, and other health

services providers. Her efforts on behalf of Baxter are focused on educating healthcare professionals in these various settings about Baxter products available to them, including product introductions and follow-up utilization and general information about the use of the products. Therefore, her representation of Baxter encompasses pre and post sales presentations. The territory for which Director Hanko is responsible covers an area extending from San Francisco, along the San Francisco/San Mateo peninsula, and south to Santa Cruz.

Director Hanko does not "take orders" or conduct actual sales transactions. Healthcare providers purchase Baxter products through independent specialty wholesale companies with whom the providers conduct orders and purchase transactions.

Baxter intends Director Hanko's representation to increase awareness and use of Baxter's products by healthcare providers within her coverage territory. Baxter therefore provides potential bonus payments to its representatives, including Director Hanko, based on overall sales of Baxter products within the representative's territory.

The company annually establishes budgets for projected sales of product groups within a territory. It then creates a formula based on a target that is a percentage of projected total sales for a representative's product group and territory. The target (e.g., 85% of projected gross sales for the calendar year) becomes a minimum threshold of overall product sales in the territory before any incentive income will be paid. If, during the year, the overall sales of the product group exceed the targeted percentage of projected sales, the representative may receive incentive compensation that increases with the amount of overall sales exceeding the minimum threshold target of gross sales. The budget and target sales formulas do not take into consideration any individual efforts by Director Hanko as a Baxter representative. The company cannot trace individual product sales to its representatives. Therefore, the budget and target sales formulas are based entirely on product gross sales performance.

The company reserves the right to, and occasionally does, change its projected sales budgets and threshold targets during the course of a year based on its evaluation of the company's health and changing market conditions. Likewise, the company reserves the right to cancel the incentive compensation program altogether, and employee representatives must acknowledge in writing that the incentive program creates no express or implied contractual right to extra compensation.

Baxter employs consultants who conduct regular surveys of Baxter product sales through the independent wholesalers that conduct actual orders and sales with providers, such as hospitals. Baxter can determine from these consultants the approximate gross sales of its products to individual purchasers. These estimates are approximate because of the method of data collection employed by the sales survey consultants. It is nevertheless possible to determine the approximate percentage of overall product sales in a given territory that are attributable to sales to a specific customer. In this manner, Director Hanko can estimate the percentage of overall Baxter sales in her coverage territory attributable to MPHS purchases at Peninsula and Mills hospitals. Based on the

year 2000 incentive compensation she received, Director Hanko estimates that approximately $1,000 of her total incentive compensation from Baxter could be attributed to MPHS purchases of Baxter products in 2000. It is likely (she has not made this calculation) that a somewhat larger amount of her year 2000 incentive compensation could be attributed to purchases of Baxter products by other Sutter-affiliated facilities in her coverage territory.

The District's Board of Directors, including Director Hanko, will be called upon to give direction to the District's negotiators, including voting on certain agreements to be incorporated in the final deal, and to ultimately vote to approve or disapprove the final agreements with MPHS, which will likely include Sutter as a signatory to the main or ancillary agreements. Final approval will also encompass the dismissal of the pending litigation.

ANALYSIS

Section 87100 of the Act prohibits a public official from making, participating in making, or otherwise using his or her official position to influence a governmental decision in which the official has a financial interest. In order to determine whether the prohibition in section 87100 applies to a given decision, Regulation 18700 provides the following eight-step analysis.

Step One: Is the individual a "public official?"

As a member of the Board of Directors of the Peninsula Health Care District, Director Hanko is a "member, officer, employee or consultant of a state or local government agency" and, therefore, is a "public official" subject to the conflict of interest provisions of the Act. (Section 82048; Regulation 18701(a).)

Step Two: Is the public official making, participating in making, or influencing a governmental decision?

A public official "makes a governmental decision" when the official, acting within the authority of his or her office or position, votes on a matter, obligates or commits his or her agency to any course of action, or enters into any contractual agreement on behalf of his or her agency. (Regulation 18702.1.) A public official "participates in a governmental decision" when, acting within the authority of his or her position and without significant substantive review, the official negotiates, advises or makes recommendations to the decision-maker regarding the governmental decision. (Regulation 18702.2.) A public official is attempting to use his or her official position to influence a decision if, for the purpose of influencing, the official contacts or appears before any member, officer, employee, or consultant of his or her agency. (Regulation 18702.3.) For purposes of the conflict of interest provisions of the Act, a public official can avoid a conflict of interest by abstaining from making, participating in making, and influencing a decision in which the official has a financial interest.

Step Three: Does the public official have economic interests?

The Act's conflict of interest provisions apply only to conflicts of interest arising from economic interests. The "economic interests" from which conflicts of interest may arise are defined in Regulations 18703-18703.5. Identifying which, if any, of these economic interests Director Hanko has is the third step in analyzing whether she has a conflict of interest under the Act. (See Regulation 18700(b)(3).) There are six kinds of economic interests:

- A public official has an economic interest in a business entity in which he or she has a direct or indirect[2] investment of $2,000 or more (Section 87103(a); Regulation 18703.1(a));

- A public official has an economic interest in real property in which he or she has a direct or indirect interest of $2,000 or more (Section 87103(b); Regulation 18703.2);

- A public official has an economic interest in any source of income, including promised income, which aggregates to $500 or more within 12 months prior to the decision (Section 87103(c); Regulation 18703.3);

- A public official has an economic interest in a business entity in which he or she is a director, officer, partner, trustee, employee, or holds any position of management (Section 87103(d); Regulation 18703.1(b));

- A public official has an economic interest in any source of gifts to him or her if the gifts aggregate to $320 or more within 12 months prior to the decision (Section 87103(e); Regulation 18703.4);

- A public official has an economic interest in his or her personal finances (expenses, income, assets, or liabilities), as well as those of his or her immediate family. (Section 87103; Regulation 18703.5).

As you state in your letter, Director Hanko has an economic interest in Baxter arising from both her employment and her stock ownership. She also may have an economic interest in MPHS, if it is determined that MPHS qualifies as a source of income to her as a result of what you have called "incentive compensation," which requires a determination as to whether Director Hanko's "incentive compensation" is, in fact, "commission income."

Generally, where commission income is received as a result of a transaction, Regulation 18704.3 controls who will be treated as the source of the income. However, "commission income" is defined in Regulation 18703.3(c)(2) to include only "gross payments received as a result of services rendered as a broker, agent, or other salesperson

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[2] An indirect investment or interest in real property means, among other things, any investment or interest owned by the official's immediate family. (Section 87103.)

for a specific sale or similar transaction." Consequently, Regulation 18703.3 does not control where a bonus is provided based on the volume of sales as contrasted with a payment received as a commission for a "specific sale or similar transaction."

However, the issue of bonuses based on volume sales, such as Director Hanko's "incentive compensation," has been addressed in the *Larsen Advice Letter*, No. I-89-555, and the *Anaforian Advice Letter*, No. I-90-312.

In *Larsen*, a Sutter County Supervisor's spouse was employed by an agricultural products processing company. The supervisor's spouse was compensated by a fixed salary, coupled with bonuses based on the volume of processing. The company's clients were primarily local farmers. In that letter, we concluded that the farmers, themselves, were the source of the income to the supervisor. This conclusion was based on the fact that the bonuses were akin to commission payments.[3]

In *Anaforian*, a Fresno City Councilmember was employed by a pharmaceutical company as a territory sales representative and district trainer, with the goal of increasing demand for the product line distributed by the company. In that capacity, the councilmember made sales calls and provided support services to anesthesiologists and anesthetists who might use the company's products. His compensation consisted of an annual fixed salary, a nominal quarterly stipend for his training services, and a quarterly bonus contingent on the overall volume of his sales of the company's products. Based on the reasoning employed in the *Larsen* letter, we concluded that the bonus was analogous to a commission and, therefore, the company's clients serviced by the council member were a source of income.

The factors considered in both decisions were: (1) the amounts of the bonuses in each case were based upon volume, and (2) the bonus payments were automatic, once the produce was processed, in the *Larsen* letter, and once sales reached a designated threshold, in the *Anaforian* letter. In addition, in the *Larsen* letter, the supervisor's spouse was able to identify the amount of the bonus payment attributable to each farmer. In the *Anaforian* letter, such specific identification was not possible. However, we concluded that, because the bonus was based on the total volume of sales, each of his clients was equally responsible for the bonuses.

In the present case, the amount of Director Hanko's "incentive compensation" is based on the total volume of sales within her coverage territory. Director Hanko is also able to estimate the portion of her "incentive compensation" that is attributable to sales to MPHS. The only feature that distinguishes Director Hanko's "incentive compensation"

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[3] For example, Regulation 18703.3 provides that the sources of commission income in a specific sale or similar transaction for a real estate agent include: (1) the broker and brokerage business entity under whose auspices the agent works; (2) the person the agent represents in the transaction; and (3) any person who receives a finder's or other referral fee for referring a party to the transaction to the broker, or who makes a referral pursuant to a contract with the broker. Further, Regulation 18703.3(c)(4) provides that for purposes of determining whether disqualification is required under the provisions of Sections 87100 and 87103(c), the full gross value of any commission income for a specific sale or similar transaction shall be attributed to each source of income in that sale or transaction.

from the bonuses in *Larsen* and *Anaforian* is that Baxter reserves the right to cancel the "incentive compensation" program, and employee representatives must acknowledge in writing that the program does not create a "right" to extra compensation. Therefore, the bonuses are not automatic in the same sense as the bonuses at issue in *Larsen* and *Anaforian*. However, we conclude that this is a distinction without a difference. The fact remains that the "incentive compensation" program is currently in effect and that, as long as the program is in effect, Director Hanko will be entitled to receive "incentive compensation" on the total sales volume in her territory, which includes MPHS. Therefore, we conclude that Director Hanko's "incentive compensation" is sufficiently similar to commission income such that MPHS is a source of income to her.

Accordingly, Director Hanko has an economic interest in MPHS.

Step Four: Are the public official's economic interests directly or indirectly involved in the decision?

A person, including a business entity or source of income, is directly involved in a decision before an official's agency when that person, either directly or by an agent:

> "(1) Initiates the proceeding in which the decision will be made by filing an application, claim, appeal, or similar request or;
> (2) Is a named party in, or is the subject of, the proceeding concerning the decision before the official or the official's agency. A person is the subject of a proceeding if a decision involves the issuance, renewal, approval, denial or revocation of any license, permit, or other entitlement to, or contract with, the subject person."
> (Regulation 18704.1(a).)

Because Baxter is not the subject of the decision at issue and did not initiate it, Director Hanko's economic interests in Baxter are indirectly involved in the decision. However, because MPHS is both a named party in and is the subject of the decision, Director Hanko's economic interest in MPHS is directly involved in the decision.

Steps Five and Six: Will the financial effect of the decision on the official's economic interest be material and reasonably foreseeable?

Once a public official identifies his or her relevant economic interests, the official must evaluate whether it is reasonably foreseeable that the decision will have a material financial effect on any of those economic interests. This determination takes two steps. First, the official must find and apply the applicable materiality standard set forth in Commission regulations. (Regulation 18700(b)(5), Regulation 18705, et seq.) After finding the applicable materiality standard, the official must then decide whether it is reasonably foreseeable that the standard will be met. (Regulation 18700(b)(6).)

Economic Interests in Baxter

The materiality standard applicable to economic interests in an indirectly involved business entity listed in the Fortune 500 is set forth in Regulation 18705.1(c), which states that the financial effect of a decision on such a business entity is material if it is reasonably foreseeable that:

> "(A) The governmental decision will result in an increase or decrease in the business entity's gross revenues for a fiscal year of $10,000,000 or more; or
> (B) The governmental decision will result in the business entity incurring or avoiding additional expenses or reducing or eliminating existing expenses for a fiscal year in the amount of $2,500,000 or more; or
> (C) The governmental decision will result in an increase or decrease in the value of the business entity's assets or liabilities of $10,000,000 or more."
> (Reg. 18705.1(c)(1).)

You have stated that there is no scenario under which the decision at issue could materially financially affect Baxter. Based on MPHS' purchases of Baxter products in the amount of approximately $387,400, it would appear that this is a correct conclusion.

Economic Interest in MPHS

Any reasonably foreseeable financial effect on a person who is a source of income to a public official and who is directly involved in a decision before the official's agency, is deemed material. (Reg. 18705.3(a).)

Since MPHS is a source of income to Director Hanko and is directly involved in the decision before her agency, any financial effect, even a penny's worth, on MPHS from the District's decision regarding the restructured relationship, including a global settlement of the litigation and the seismic compliance issues, is deemed material.

Regulation 18706 provides that "[a] material financial effect on an economic interest is reasonably foreseeable, within the meaning of Government Code section 87103, if it is substantially likely that one or more of the materiality standards (see Cal. Code Regs., tit. 2 §§ 18704, 18705) applicable to that economic interest will be met as a result of the governmental decision." A financial effect need not be a certainty to be considered reasonably foreseeable. (*In re Thorner* (1975) 1 FPPC Ops. 198.)

You have suggested several possible outcomes of the issues currently facing the District, any one of which is substantially likely to have a financial effect on MPHS. In fact, it is difficult to imagine a scenario under which a financial effect on MPHS is not reasonably foreseeable. As a result, the materiality standard for Director Hanko's economic interest in MPHS will be met, and she may not participate in the discussions or

the decision regarding the litigation and "restructured relationship" between the District and MPHS.

Steps Seven and Eight: Exceptions

We have not gone on to analyze the latter two steps. Step seven is an exception that applies where the reasonably foreseeable and material financial effect on the official's economic interest is not distinguishable from the effect on the public generally, and step eight is an exception that applies when the official is legally required to participate in the decision. You have not provided any facts to suggest that these exceptions may apply.

If you have any other questions regarding this matter, please contact me at (916) 322-5660.

Sincerely,

Luisa Menchaca
General Counsel

Holly B. Armstrong

By: Holly Armstrong
Staff Counsel, Legal Division

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