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New Compliance Plan Oversight Developments

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Several recent regulatory initiatives and judicial decisions offer important guidance to health lawyers on the board's compliance plan oversight obligations. These include: (1) the national implications of New York state initiatives to increase the compliance plan oversight duties of Medicaid providers and their boards; (2) new Delaware case law further interpreting the board's core *Caremark* oversight obligations; and (3) an Internal Revenue Service (IRS) commitment to increase its criminal tax-enforcement activity in the exempt organization sector. Individually and collectively, these developments may influence the vigor with which boards effect their compliance plan oversight duties.

The New York State Initiative

Recent compliance plan initiatives instituted by the New York state Medicaid program apply a groundbreaking level of emphasis on the effectiveness of a provider's corporate compliance plan and the degree of oversight expected to be exercised by its governing board.[1] Given the state's prominence, the size of its Medicaid population, and the national reputation of Inspector General James Sheehan, these New York initiatives may ultimately spark similar actions in other states.

With Respect to Plan Effectiveness

State regulations (effective October 1, 2009) will require New York Medicaid providers and their governing boards to adopt and implement an "effective" corporate compliance plan, and ultimately certify to its effectiveness, according to standards to be established by the New York State Office of the Medicaid Inspector General (OMIG). An effective

[1] 18 N.Y.C.R.R. Sec. 521.1 *et seq.*, *available at* www.omig.state.ny.us/data/content/view/79/65.

compliance plan will reflect a provider's size, complexity, resources, and culture.[2] At a minimum, compliance plans shall be required to address: topics related to billings to and payments from the Medicaid program; issues of medical necessity and quality of care; corporate governance; mandatory reporting; credentialing; and other risk areas as reasonably identified by the provider.

Such compliance plans also shall be required to incorporate a series of elements that are consistent with other published regulatory guidance on effective compliance plans,[3] e.g., a written code of conduct containing compliance expectations; the designation and description of duties of a chief compliance officer; a plan for compliance-based training and education of all provider employees, executives, and board members; accessible lines of communication (including but not limited to "hotline"-like mechanisms) by which persons may internally report compliance issues; disciplinary procedures for compliance violations; self-identification of compliance risks; and a policy of non-intimidation and non-retaliation for good-faith participation in the compliance program.[4]

Particularly noteworthy is the requirement that providers shall annually certify to OMIG that their compliance program satisfies the regulatory requirements regarding provider conduct and implementation. This certification will be made on a form to be provided on the OMIG's website. Specific compliance program guidelines for certain types of providers are expected to be prepared in the future by the OMIG and also posted on its website.

Failure to comply with the new regulatory requirements could subject a provider to sanctions or penalties, including but not limited to revocation of the provider's Medicaid participation agreement. It is unclear whether such sanctions would extend to board members who did not exercise oversight of the manner in which the provider was to have complied with the regulations (*see* following discussion).

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[2] *Id.*

[3] *See*, *e.g.*, United States Sentencing Guidelines, Department of Justice Guidelines for the Prosecution of Corporations, HHS/OIG Compliance Program Guidance for Hospitals.

[4] *Id.* at n.2.

As to Board Liability

The new regulations combine with comments made in the OMIG's 2009-2010 Work Plan[5] to increase the board's compliance plan oversight obligations. Indeed, the Work Plan indicates that, in extreme situations, individual board members could be sanctioned for failing to satisfy their oversight obligations.

From a general perspective, the Work Plan references the board's duty to maintain "reasonable oversight" of the provider's compliance plan. In this manner, the Work Plan is consistent with expectations of fiduciary conduct set forth in the seminal *Caremark* decision[6] and subsequent statements by the Delaware courts (*see* discussion of *CitiGroup* below). More important is the extent to which the OMIG expects to hold board members accountable for the quality of their oversight activity. Specifically, during the course of a provider audit or examination, the OMIG will consider whether the provider's board has "exercised reasonable oversight over information and reporting systems." Thus, during any such audit or investigation, the OMIG can be expected to consider whether specific compliance program deficiencies are attributable, in whole or in part, to poor board oversight. The OMIG will then consider the application of sanctions against individual board members in "appropriate circumstances" where it can be determined that the board member "significantly failed" to satisfy his/her oversight duties. It would appear that such oversight duties would relate to the new annual certification obligations discussed above, among other duties.

National Implications

These New York initiatives are particularly unique to the extent that they: (1) represent the first state-level regulatory effort to mandate compliance plan effectiveness as a precondition to Medicaid participation; (2) in so doing, incorporate issues of medical necessity and quality of care into the compliance plan effectiveness criteria; (3) formally ascribe accountability to the governing board for material compliance plan effectiveness failures; and (4) establish a specific annual certification process that will require greater institutional (and board) attention to the effectiveness of the plan itself.

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[5] *See* www.omig.state.ny.us/data/images/stories/work_plan/omig_work_plan_2009_2010.pdf.
[6] *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996); *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).

From a broader perspective, what is most notable about the new initiatives is their potential to prompt similar actions in other states; i.e., acting as a dam breaker event that will encourage Medicaid and even charity regulators in other states to pursue similar regulations. This is particularly the case given the state-level emphasis on reducing Medicaid fraud and preserving charitable assets, and the broader national focus on addressing healthcare quality issues both as a matter of governance oversight and compliance management.[7] Accordingly, New York Medicaid providers—and their governing boards—are well advised to consult with their counsel on how best to recalibrate their internal compliance plan procedures to comply with the new regulations. Health lawyers serving clients in other states will want to advise their clients of the New York initiatives' significance and counsel them on an appropriate response.

Director Oversight Duties

The Delaware Chancery Court's recent decision in the *In Re Citigroup* litigation[8] adds a useful clarification to the *Caremark* standard, and of the distinctions between director obligations to monitor compliance, as opposed to business risk.

The case was instituted as a derivative action against current and former Citigroup directors and officers. The shareholder/plaintiffs sought recovery for the company of its losses arising from exposure in the subprime lending market. The specific allegations included breach of fiduciary duty by failing to properly manage subprime investments, especially in the face of supposed red flags of potential liability that the defendants allegedly ignored in their pursuit of short-term profits (and failing to disclose the associated corporate exposure). In essence, the plaintiffs sought to assert a *Caremark*-based director oversight-based claim for failure to monitor liability creating activities; i.e., that the current and former directors should be held liable because they "should have known" of the extraordinary risks of the subprime investments.[9]

[7] *See*, *e.g.*, U.S. DEP'T OF HEALTH AND HUMAN SERVS. OFFICE OF INSPECTOR GEN. AND AMERICAN HEALTH LAWYERS ASS'N, CORPORATE RESPONSIBILITY AND HEALTH CARE QUALITY: A RESOURCE FOR HEALTH CARE BOARDS OF DIRECTORS, *available at* http://oig.hhs.gov/fraud/docs/complianceguidance/CorporateResponsibilityFinal%209-4-07.pdf.
[8] *In re Citigroup Inc. Shareholder Derivative Litig.*, 964 A.2d 106 (Del. Ch. 2009).
[9] The case addressed the defendants' motion to dismiss the plaintiff's complaint for failure to plead with particularity that a demand on the board to pursue litigation would have been futile under Court of

Of course, *Caremark* is generally interpreted as establishing the director's fiduciary obligation to assure the establishment and implementation of a corporate compliance plan. Together with the subsequent decision in *Stone v. Ritter*,[10] it has served as a primary reference point for boards seeking to evaluate the extent of their compliance oversight duties. In *Citigroup*, the Delaware Chancery Court was given the opportunity to revisit the *Caremark/Stone* director oversight standards under an extreme fact pattern—the company's near-catastrophic investment losses that played such a notorious role in the 2007-2008 financial crisis.

The *Citigroup* court confirmed the *Caremark/Stone* standard for oversight liability as based on the concept of good faith embedded in the core duty of loyalty—rather than constituting a separate fiduciary duty that could provide an independent basis for liability. To establish a *Caremark/Stone*-based claim for oversight liability, a plaintiff must demonstrate "that the directors knew they were not discharging their fiduciary obligations or that the directors demonstrated a conscious disregard for their responsibilities, such as by failing to act in the face of a known duty to act."[11] Thus, *Caremark/Stone* liability is rooted in bad faith; i.e., a demonstration of bad faith is a necessary condition to establishing director oversight liability.[12]

The court declined to extend the concept of director oversight liability to subject directors to personal liability for "failure to predict the future and properly evaluate business risk." In so doing, the court drew an important distinction between the typical *Caremark* claim and the specific allegations of the plaintiffs in this case. In the former situation, the plaintiff(s) will claim that the defendants are responsible for damages

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Chancery Rules. Ultimately, the court dismissed all but one of the claims, holding that the current and former directors were not liable for the corporation's subprime investment losses.

[10] *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).

[11] *In re Citigroup*, *supra*, p. 4, 17. With respect to director liability where directors are alleged to be liable for a failure to monitor liability creating activities, while directors can be liable for a failure to monitor, only a sustained or systemic failure of the board to exercise oversight—such as the utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability. In other words, the necessary conditions predicate for director oversight liability are: (a) the directors utterly fail to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously fail to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. *Id.*

[12] Bad faith conduct may be found where a director intentionally acts with a purpose other than that of advancing the best interests of a corporation, acts with the intent to violate applicable positive law, or intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. *In re Citigroup*, *supra*, p. 19.

resulting from their failure to properly monitor or oversee employee misconduct or violations of law. For example, in *Caremark*, the board allegedly failed to monitor employee violations of the federal Medicare anti-kickback statutes; in *Stone*, the allegation was that the board failed to monitor employee violations of the federal Bank Secrecy Act. In *Citigroup*, the plaintiff's claims were based on the alleged failure of the board and officers to properly monitor business risk; i.e., "that the director defendants should be personally liable to the Company because they failed to fully recognize the risk posed by subprime securities." The *Citigroup* court thus rejected the application of a director oversight liability theory where the plaintiffs failed to allege facts that could demonstrate "bad faith."[13] To do so would be contrary to the basic principles of the business judgment rule.

Thus, the *Citigroup* decision affirms the basic principles of the oversight liability theory; i.e., that bad-faith conduct is a perquisite for ascribing director liability for failure to properly monitor corporate compliance activities. This is an extremely high burden of proof, which likely could be satisfied only in the most egregious of circumstances. However, such circumstances have a very unfortunate habit of arising in health industry boardrooms. Further, there is no assurance that healthcare or state charity regulators would consider themselves bound by a bad-faith liability standard in investigating allegations of lax board compliance oversight. This may particularly be the case when the allegations relate to "preventable harm" to the corporation (e.g., substantial monetary compliance fines).

"EO" Criminal Tax Enforcement

Compliance committees of nonprofit hospitals may wish to note the announcement that the IRS intends to take steps to enhance its Tax-Exempt Criminal Fraud program. A recently released report by the Treasury Inspector General for Tax Administration recommended that the IRS' Tax-Exempt/Government Entities (TE/GE) Division adopt a

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[13] "Director oversight duties are designed to ensure reasonable reporting and information systems exist that would allow directors to know about and prevent wrongdoing that could cause losses for a company. There are significant differences between failing to oversee employee fraudulent or criminal conduct and failing to recognize the extent of a company's business risk. While it may be tempting to hold directors to a similar standard with respect to monitoring business risk, doing so would require courts to engage in conducting hindsight evaluations contrary to the principles of the business judgment rule." *In re Citigroup*, *supra*, p. 23.

more centralized, "corporate" approach to identify and investigate allegations of possible fraud in the tax-exempt sector.[14] The Report was generally supportive of the existing TE/GE fraud program, but concluded that the program could increase its efficiency and effectiveness by assuring that specific fraud controls are in place at all five TE/GE offices, and being more attentive to referrals of individuals outside of an EO who may misuse the organization for tax purposes. Absent the adoption of centralized executive direction and oversight, the Report concluded that a series of issues would continue to prevent the TE/GE fraud program from successfully managing fraud risk in the exempt organizations area.

This release represents the "flip side" to the IRS' "warm and gentle" approach to advising the EO community on basic tax-compliance issues such as governance and intermediate sanctions. At its most basic, the Report is a reminder that criminal tax fraud *can* and *does* exist in the EO community. Of particular importance to EO audit and compliance committees is the recommendation that the IRS internally reorganize (i.e., adopt a "corporate approach") in order to enhance the effectiveness of its criminal tax-enforcement capabilities. Furthermore, the Report's link between a weak board structure and the potential for criminal tax fraud should not be lost on EOs struggling with governance issues. Yet, if the IRS proceeds to "ramp up" its enforcement efforts, it will be incumbent upon the agency to increase EO community awareness as to the specific indicia of criminal fraud; what kind of conduct are we talking about, specifically, beyond the obvious (e.g., omission of income, claiming false expenses and/or deductions, filing altered or false documents, evading payment or misusing EO status)? The EO community will need details.

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[14] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, A CORPORATE APPROACH IS NEEDED TO PROVIDE FOR A MORE EFFECTIVE TAX EXEMPT FRAUD PROGRAM, July 6, 2009, *available at* www.treas.gov/tigta/auditreports/2009reports/200910096fr.pdf.; Fred Stokeld, *Tax Exempt/Government Entities Division Will Centralize Antifraud Efforts*, (Number/AA0E29E&AA59C780852560F) (Aug. 11, 2009).

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