

NEW GUIDANCE TO GOVERNING BOARD ON COMPLIANCE PLAN OVERSIGHT

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One of the most critical duties of a governing board in a regulated industry such as health care is to exercise oversight of the organization's corporate compliance plan. Thus is noteworthy a series of recent judicial and regulatory developments which offer refinement and guidance on the exercise of this important duty. These developments include: (a) new Delaware case law interpreting the seminal *Caremark* obligation; (b) the Department of Justice's new "McNulty Memorandum"; (c) the settlement agreement between the California Attorney General and Hewlett-Packard; (d) compliance-related speeches by SEC officials; and (e) a recent OIG corporate integrity agreement.

I. REVIEW: THE CORE DUTY OF OVERSIGHT

The directors' duty to oversee the corporate compliance program is articulated (*in dicta*) in the seminal decision, *In re Caremark International, Inc., Derivate Litigation*.¹ The *Caremark* court concluded that a director's obligation includes a duty to attempt in good faith to assure that (a) a corporate information and reporting system, which the board concludes is adequate, exists; and (b) this system is sufficient to assure that appropriate information regarding organizational compliance with applicable laws will come to the board's attention in a timely manner and in the ordinary course.² The level of detail that is adequate for such an information and reporting system is a matter of the board's business judgment. The court did, however, acknowledge that no rationally designed information and reporting system could be expected to remove the possibility

that the organization will violate applicable laws or otherwise fail to identify corporate acts potentially inconsistent with law.³

The *Caremark* court observed that a director's failure to reasonably oversee the implementation of such a system/compliance plan could under certain circumstances (and in theory), expose the directors to breach of the duty of care exposure.⁴

In the health care industry, guidance on the implementation of the *Caremark* obligation has been provided through a number of sources: (a) OIG Compliance Program Guidance⁵; (b) two separate sets of compliance-based educational guidance for health care directors published jointly by OIG and AHCA⁶; and (c) the United States Sentencing Guidelines manual.⁷ The 2004 Amendments to the Sentencing Guidelines serve, importantly, to expand the director's obligation beyond mere implementation of the compliance plan.⁸ Specifically, the amendments require directors to be "knowledgeable about the content and operation of the . . . program . . .", to exercise such oversight with diligence, and to promote a 'culture of compliance' within the organization.⁹

Also noteworthy are the "obstruction of justice" provisions of Sections 802 and 1102 of the Sarbanes-Oxley Act, which apply to all types of organizations, not just publicly held entities.¹⁰

The following new developments serve to favorably contribute to this body of work, providing guidance to governing board members on their vitally important compliance plan oversight obligation. As such, they are useful resources for the corporate counsel.

1. STONE V. RITTER: GOOD NEWS FOR THE BOARD?

The Delaware Supreme Court recently affirmed the *Caremark* standard as the basis for assessing director oversight liability, in two separate rulings on shareholder derivative claims¹¹. In so doing, the court applied useful *Disney* "gloss" on the relationship between "good faith" and the exercise of oversight responsibility, and confirmed the "high bar" for establishing director culpability.

In *Stone v. Ritter*, the shareholders did not claim that the directors “knew or should have known” of the banking law violations that led to a \$50 million penalty against the corporation (AmSouth). Rather, the shareholders claimed that the directors “utterly failed to implement any sort of statutorily required monitoring, reporting or information controls that would have enabled them to learn of problems requiring their attention.” Applying *Caremark*, the Chancery Court had dismissed the derivative claim, concluding that the shareholders had failed to plead that the board was ever aware of “red flags”, and that the board chose to do nothing about problems it allegedly knew existed.

In affirming the dismissal, the Supreme Court confirmed that *Caremark* articulates the necessary conditions under Delaware law for director oversight liability. These conditions are that the directors either: (a) “utterly failed to implement any reporting or information system or controls, or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.”¹² Thus, fiduciary liability exposure arises only upon a showing that the directors knew they were not discharging a fiduciary obligation; *i.e.*, failing to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities.¹³

The Supreme Court observed that the *Caremark* focus on director failure to act in “good faith” is consistent with the definition of “bad faith” approved by the Court in its recent *Disney* decision.¹⁴ There, the Supreme Court held that a failure to act in good faith requires conduct that is “qualitatively different from, and more culpable than, the conduct giving rise to a violation of the fiduciary duty of care (*i.e.*, gross negligence).”¹⁵ Thus, under a *Caremark / Disney* standard, the lack of good faith conduct that is a necessary condition for director oversight liability is “a sustained or systematic failure of the board to exercise oversight.”¹⁶

In affirming the Chancery Court’s decision, the Supreme Court observed that the shareholders were equating “bad outcome” with “bad faith”. Indeed, the *Stone* record demonstrated that the board maintained a compliance plan, received and approved

relevant policies and procedures, and exercised oversight by relying on periodic reports from compliance personnel. “In the absence of red flags, good faith in the context of oversight must be measured by the directors’ actions” to assure that a reasonable corporate compliance plan exists, and not by “second guessing” after the occurrence of employee conduct that creates the legal risk.¹⁷ The failure of employees to report deficiencies to the board did not, thus, serve as a basis for an oversight liability claim against the directors.

Stone provides helpful guidance by confirming standards of director liability under *Caremark*, with a particular *Disney* “good faith” gloss. The standard for oversight liability remains “quite high” and thus (at least under Delaware law) is unlikely to be met in the presence of a compliance plan with a modicum of director oversight (e.g., periodic reporting to a board committee). Delaware cases are worthy of note by nonprofit corporations because of the number of businesses incorporated in Delaware, the volume of business controversies litigated in Delaware courts, the strength of its judiciary (including a specialized court, the Chancery Court, that has jurisdiction over cases arising under its corporate laws), and the fact that it has a unified corporation code applicable to for-profit and nonprofit corporations alike. Furthermore, Delaware decisions often address alleged violations of fiduciary duty that closely resemble those duties owed by directors of nonprofit corporations. Accordingly, rulings of Delaware courts on issues of director conduct can be particularly informative to nonprofit organizations – and those who regulate them – even where those organizations are not governed by Delaware law.

However, it should not be presumed that a state charity official, when confronted with allegations of compliance plan oversight-related gross negligence or bad faith conduct by a nonprofit board, would automatically defer to *Stone*, *Caremark* and *Disney*. This is especially the case with respect to nonprofit boards which have tolerated dysfunctional compliance plans,¹⁸ resulting in significant financial penalties to the organization. While the *Stone* logic may ultimately “carry the day,” it may not deter the charity officials from closely scrutinizing board conduct in such a case.

2. THE MCNULTY MEMORANDUM

The recently announced revisions to the Department of Justice's guidelines for the prosecution of corporations contain a specific corporate compliance component.¹⁹ Much of the focus on the "McNulty Memorandum" has, fairly, been on the addition of new restrictions for prosecutors seeking privileged information from corporations. Noteworthy, however, is the fact that the McNulty Memorandum (at Section IX) preserves (almost verbatim) the lengthy and detailed discussion from its predecessor document (the "Thompson Memorandum") on the characteristics of an effective corporate compliance program. This particular discussion offers extraordinarily practical guidance on compliance plan structure and oversight.

The Department of Justice views corporate self-policing favorably, and will consider the existence and adequacy of a corporation's pre-existing compliance program in reaching a decision as to the proper treatment of a "corporate target". Yet, the guidelines make it clear that the mere existence of a compliance program is not, in and of itself, sufficient to justify not charging a corporation. (Indeed, the commission of crimes in the face of a compliance program may suggest that the corporate management is not adequately enforcing its program). The focus of the government's inquiry is whether the program is designed and implemented in an effective manner, or is a mere "paper" plan. The critical factor is "whether the program is adequately designed for maximum effectiveness in preventing and defeating wrongdoing by employees and whether corporate management is enforcing the program or is tacitly encouraging or pressuring employees to engage in misconduct to achieve business objectives."²⁰ Important to this analysis is whether the governing board exercises the level of compliance plan oversight as contemplated in *Caremark*.

The Department of Justice has no formal guidelines for corporate compliance programs. Particularly instructive, though, is the list of basic questions set forth in the Memorandum, which may be asked by the government in determining compliance plan effectiveness (see attached chart). These questions are direct and "to-the-point"; corporate compliance officials, general counsel and board members will all benefit from

a familiarity with these questions and are well advised to apply them to their own organizational program.

What is particularly noteworthy about the McNulty Memorandum is that it speaks to corporate conduct designed to influence a decision by the Department of Justice on whether to charge a corporate defendant. This is in comparison to the compliance plan effectiveness criteria set forth in the Federal Sentencing Guidelines Manual, which are designed to influence a sentencing decision, after treatment and resolution have been reached; *i.e.*, these two sets of guidelines approach the central issue of compliance plan oversight from different, yet complimentary perspectives and thus both should be considered by the board in evaluating its oversight obligations.

3. THE H-P SETTLEMENT

The December 7 settlement of alleged privacy violations between the California Attorney General and Hewlett-Packard offers a series of compliance-related governance protocols which may be worthy of consideration by health care organizations.²¹ This is especially the case given the intense health industry regulatory focus on privacy matters and, increasingly, an industry practice of conducting internal investigations. The most relevant of these protocols include:

- Identification of a new independent director to serve as the board's "watchdog" on legal and ethical compliance matters.
- This director is to have specific responsibilities in effecting that oversight function and to report violations to the board, other "responsible" HP officials and to the Attorney General.²²
- Expanding the oversight and reporting duties of the HP Chief Ethics and Compliance Office ("CECO") to include HP's investigative practices. The CECO will have a dual reporting relationship (to both the HP General Counsel and to the Audit Committee) and will have the authority to retain independent counsel.

- Expanding the duties of the chief privacy officer to review the HP investigation protocols to ensure they protect privacy and comply with ethical requirements.
- Establishing a new “Compliance Council”, chaired by the CECO and also including the chief privacy officer, deputy general counsel for compliance, head of internal audit, and ethics and compliance liaisons. The purpose of the Council is to develop and maintain policies and procedures governing the HP ethics and compliance program and periodically report to the CFO, Audit Committee.²³
- Redesigning the ethics and conflicts of interest components of the HP training program, in a manner supervised by the CECO, the Compliance Council, independent director and chief privacy officer.
- Creating a separate code of conduct addressing privacy and ethics concerns, for use by outside investigators.

Of course, the HP “pretexting scandal” was a most extraordinary and unique development, with little direct application to the health care sector. However, it is highly significant to note that the scandal evolved around two concepts of absolute relevance to health care corporations: the duty of directors to preserve the confidentiality of proprietary corporate information, and the legal and ethical parameters of privacy matters and internal investigations. Further, the settlement agreement emphasizes coordination of all internal components of an organization’s compliance effort, which is a much-emphasized goal in health care.

4. CORPORATE INTEGRITY AGREEMENTS

The September 27, Corporate Integrity Agreement between the OIG and Tenet Healthcare²⁴ reflects an increased focus on the role of corporate governance in effecting compliance plan and corporate integrity oversight.

Specifically, the CIA obligates Tenet's "Quality, Compliance and Ethics Committee" to, among other things, (a) be comprised of independent directors; (b) meet at least on a quarterly basis for the review and oversight of the compliance program (including key officer and committee performance reviews); (c) arrange for the performance of a compliance plan effectiveness review during each reporting period for the CIA, and to assess the results of that review; (d) retain an independent compliance expert to advise the Compliance Committee in the conduct of its duties; and (e) execute a resolution, for each CIA reporting period, summarizing the Committee's review and oversight of the system's compliance with the CIA. Also particularly relevant, from a corporate governance perspective, is the emphasis of the CIA on the promotion of clinical quality, and on compliance and quality-related performance standards and incentives for corporate management.

It is important to recognize that these compliance oversight obligations arise solely in the context of the facts and circumstances of the CIA. However, the broader significance of these obligations is the extent to which they reflect the importance that OIG places on the health care board's basic "*Caremark*" compliance plan oversight obligation. It may thus be a worthwhile use of time for corporate counsel to discuss with the compliance committee (and maybe the full board) the following governance-related compliance plan issues that, from our view, are raised by this CIA:

- The independence of the members of the compliance committee.
- The frequency of the committee's reports to the full board.
- The frequency of the chief compliance officer's reports to the full board.
- The freedom of the chief compliance officer to report directly to the full board at any time.
- The reporting relationships between the compliance officer, the general counsel and the chief financial officer.
- The regular education of compliance committee members.

- The extent to which issues of quality of care are within the jurisdiction of the compliance committee (e.g., the potential for False Claims Act exposure for false information or statements in quality reporting data).
- The use of compliance and quality-based performance standards for corporate executives.
- The compliance plan oversight obligations of subsidiary boards.²⁵

5. SEC PERSPECTIVE

Some of the most constructive regulatory observations on the board's compliance plan oversight obligations come from public comments and speeches of SEC officials. While obviously directed at publicly traded companies, these observations often transcend corporate form with their practicality and relevance. For example, Lori A. Richards, the SEC's Director of Office of Compliance Inspections and Examinations, recently spoke to the compliance plan guidelines set forth under the Federal Sentencing Guidelines. With respect to the board's oversight role she noted the following favored practices:

- The role of the governing board in establishing "the tone at the top"; *i.e.*, the importance of making it clear that senior leadership expects the firm and all of its employees to operate ethically and consistent with fiduciary and legal obligations.
- The importance attributed to the board receiving regular reports of compliance problems, issues and concerns, and to the chief compliance officer (periodically) meeting with the board to discuss the state of compliance within the organization.
- The manner in which senior leadership makes it clear (in many different ways) that the organizational decision making process will be guided by a compliance-oriented philosophy.

- Evidencing the culture of compliance through decisions that demonstrate intolerance for non-compliance.²⁶

These comments are consistent with other compliance-based comments of SEC officials, who regularly emphasize the important role of the board (and of the senior executive leadership), in establishing a “tone at the top” with respect to an organizational culture of compliance.²⁷

II. SUMMARY

These developments, both individually and collectively, speak clearly to the important role that the governing board plans in terms of compliance plan oversight. They offer a basis from which corporate counsel may advise boards on how best to implement their oversight obligations. However, they should not be interpreted as providing blanket protection, especially in those situations where the board has intentionally declined to monitor compliance matters or has deferred oversight to executive leadership, or where executive management has not adequately involved governance in the compliance oversight role.

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¹ 698 A 2d. 959 (Del. Ch 1996)

² *Id.*, p. 970..

³ *Id.*, p. 970.

⁴ *Id.*, p. 970.

⁵ See, e.g., OIG Compliance Program for Hospitals, 63 Fed. Reg. 8987 (Feb 23, 1998), OIG Supplemental Compliance Program Guidance for Hospitals, 70 Fed. Reg. 4958 (Jan. 31, 2005).

⁶ “Corporate Responsibility and Corporate Compliance: A Resource for Health Care Boards of Directors”, The Office of Inspector General of the U.S. Department of Health and Human Services, and the American Health Lawyers Association (“AHLA”) (2003). “An Integrated Approach to Corporate Compliance: A Resource for Health Care Organizations Boards of Directors”; The Office of Inspector General of the U.S. Department of Health and Human Services; and the American Health Lawyers Association (2004).

⁷ 2006 Federal Sentencing Guidelines Manual, Chapter 8, § 8B2.1 “Effective Compliance and Ethics Program”. http://www.ussc.gov/2006guid/8b2_1.html

⁸ Federal Sentencing Guidelines § 8B2.1 (a) (Commentary, p. 3).
http://www.ussc.gov/2006guid/8b2_1.html

⁹ *Id.*, at p. §§ 81B2.1(b), 8B2.1(b), (2)(B).

¹⁰ 18 U.S.C. § 1519, 18 U.S.C. § 1512.

¹¹ *Stone v. Ritter*, 2006 Del. LEXIS 597, Nov. 6, 2006. Also decided by the Supreme Court in a same day ruling with no discussion other than a citation to *Stone* was *Profit Sharing Account v. Armstrong*, Del. No. 110, 2006. See also, BNA’s Corporate Accountability Reporter, December 1, 2006 (Vol. 4, No. 46, p. 1184). [It is important to remember that the *Caremark* decision itself arose from a derivative action, and many of the subsequent decisions applying *Caremark* also involved derivative complaints.]

¹² *Stone v. Ritter*, *supra* at 6.

¹³ *Id.*

¹⁴ *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27 (Del. 2006).

¹⁵ *Id.*, at 66-67.

¹⁶ *Id.*, **Note**: Some commentators have observed that unlike the *Caremark* Court’s focus on the duty of care and the Business Judgment Rule, the *Stone* Court approached the issue from the perspective of the duty of loyalty. *Stone, supra*, p. 6. “. . . [A] showing of bad faith conduct, in the sense described in *Disney* and *Caremark*, is essential to establish director oversight liability, the fiduciary duty violated by that conduct is the duty of loyalty.”

¹⁷ *Stone, supra*, p. 19.

¹⁸ *E.g.*, little or no reporting is made to the board, the board does not participate in compliance plan review to any degree, the board is unaware of compliance plan funding, staffing, or qualifications of the compliance officers.

¹⁹ U.S. Department of Justice Memorandum, Principles of Federal Prosecution of Business Organization, December 12, 2006. http://www.usdoj.gov/dag/speech/2006/mcnulty_memo.pdf (a/k/a “McNulty Memorandum”).

²⁰ *Id.*, p. 14.

²¹ www.ag.ca.gov

²² Conversations with the Attorney General’s office suggests that this unique assignment is restricted to investigation oversight and privacy matters, and that it supplements the Board’s care compliance oversight function.

²³ In some respects, this “Compliance Council” is a formal manifestation of the integration of various legal and compliance functions called for by OIG and AHLA in their 2004 publication, “An Integrated Approach to Corporate Compliance: A Resource for Health Care Organizations Boards of Directors”.

²⁴ <http://www.tenethealth.com/NR/rdonlyres/0D2B70E7-9810-4146-B0A6-F3C4B9212929/104341/TenetCIA1.pdf> (Originally entered into on June 28, 2006).

²⁵ Note also the recent commentary of OIG on the deficiencies of compliance plans of certain stand-alone Part D Medicare prescription drug plan sponsors. <http://oig.hhs.gov/oei/reports/oei-03-06-00100.pdf>

²⁶ Speech, “The Process of Compliance,” Lori A. Richards, Director, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, October 19, 2006. <http://www.sec.gov/news/speech/2006/spch101906lar.htm>

²⁷ Speech, “Tone at the Top: Getting it Right”, Stephen M. Cutter, Director, Division of Enforcement, U.S. Securities and Exchange Commission, December 3, 2004. <http://www.sec.gov/news/speech/spch120304smc.htm>

**Compliance Plan Effectiveness Criteria
Department of Justice Guidelines
Prosecution of Corporations**

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FUNDAMENTAL QUESTIONS:	<ul style="list-style-type: none"> ▪ Is the corporation's compliance program well-designed? ▪ Does the corporation's compliance program work?
CRITICAL FACTORS IN EVALUATION:	<ul style="list-style-type: none"> ▪ Is the program adequately designed for maximum effectiveness in preventing and detecting wrongdoing by employees? ▪ Is corporate management enforcing the program or is it tacitly encouraging or pressuring employees to engage in misconduct to achieve business objectives?
GOVERNANCE-RELATED EVALUATION CONSIDERATIONS:	<ul style="list-style-type: none"> ▪ Do corporate directors exercise independent judgment review over proposed corporate action rather than unquestioningly ratifying officers' recommendations? ▪ Are directors provided with information sufficient to enable the exercise of independent judgment? ▪ Are internal audit functions conducted at a level sufficient to ensure their independence and accuracy? ▪ Have the directors established an information and reporting system in the organization reasonably designed to provide management and the board with timely and accurate information sufficient to allow them to reach an informed decision regarding the organization's compliance with the law?
OTHER EVALUATION FACTORS:	<ul style="list-style-type: none"> ▪ Has the corporation provided for a staff sufficient to audit, document, analyze and utilize the results of the corporation's compliance efforts? ▪ Are the corporation's employees adequately informed about the compliance program? ▪ <i>Are the corporation's employees convinced of the corporation's commitment to the compliance program? [NOTE: emphasis added]</i>
SUPPLEMENTAL CONSIDERATIONS:	<ul style="list-style-type: none"> ▪ Comprehensiveness of compliance program; ▪ Extent and pervasiveness of criminal conduct; ▪ Number and level of corporate employees involved; ▪ Seriousness, duration and frequency of the misconduct; and ▪ Remedial actions taken by the corporation.

Source: U.S. Department of Justice, "Principles of Federal Prosecution of Business Organizations" (Section VIII: "Charging a Corporation: Corporate Compliance Programs"). www.usdoj.gov.