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by Gabriel L. Imperato, Esq., CHC and Joseph Picone, Esq.

Board oversight: Fiduciary duty of care and individual liability

» Board members are expected to oversee an organization's compliance program.

» Board members have a duty of care in the oversight of compliance programs and in decision-making functions.

» Board members should act in good faith and with the care an ordinary, prudent person would exercise under similar circumstances.

» If board members meet these standards, they will generally be protected from individual liability.

» Federal and state laws provide great protection to whistleblowers, and board members who act in retaliation against an individual engaged in "protected activity" can be held personally accountable.

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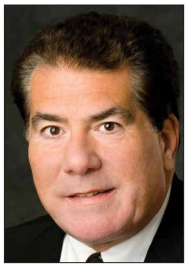
Directors of healthcare organizations have important responsibilities relating to corporate compliance requirements that are unique to the healthcare industry. The risks of non-compliance have grown dramatically over the last decade for healthcare organizations as the government has dedicated substantial resources to respond to healthcare fraud and abuse. Private whistleblowers, in addition to government investigators and auditors, also play a significant and unpredictable role in identifying improper practices and establishing liability for individuals and organizations.

The applicable duty-of-care standard requires that a director exercise his/her oversight functions to institute a proper compliance program to root out and prevent the occurrence of unlawful activities within the organization. When a director of any organization is made aware of allegations of unlawful activities and compliance violations, part of the remedy is an effective compliance program. Unfortunately, even the most expansive and effective compliance program may not prevent the occurrence of all unlawful or non-compliant activity or an external enforcement action or whistleblower case.



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An organization may be made aware of compliance violations by an internal whistleblower. Sometimes, organizations address this type of development by either terminating the reporter-employee or entering into a "severance agreement." In light of this type of response, a variety of federal laws and statutes provide anti-retaliation protection to such individuals.

Generally, board members are not held individually liable for breaching their fiduciary obligations for management decisions, including those resulting in termination of an employee who has engaged in protected activity. However, a recent decision from the

United States District Court for the Northern District of California[1] demonstrates a potential shift in this principle. Accordingly, a basic understanding of the director's fiduciary obligations and how the duty of care should be exercised in overseeing an organization's compliance program has become essential for board members.

Board member fiduciary obligations

Directors of healthcare organizations face unique challenges associated with conducting business in the healthcare industry that may be unfamiliar to those employed in other industrial or service sectors. Providers and suppliers of healthcare goods and services are subject to complex statutory and regulatory schemes governing coverage and reimbursement for medical services.

In wake of the *Caremark* and *Stone* decisions,[2] it is clear that directors of healthcare organizations owe a fiduciary duty to shareholders concerning compliance with the law. The one fiduciary duty specifically implicated by corporate compliance programs is the duty of care.[3] The basic fiduciary duty of care typically requires a director to act in good faith with the care an ordinary, prudent person would exercise under similar circumstances in a manner they reasonably believe to be in the best interests of the organization. In the healthcare context, the duty of care arises in either the decision-making function or the oversight function. Most often, a director's duty of care with respect to a corporate compliance program involves the oversight function.

Generally, this oversight function is satisfied if the director assures that a compliance program exists, is properly funded, and adequately provides the board with information relevant to make decisions. However, the mere existence of a compliance program is not by itself sufficient to shield the board from oversight liability. The program must be adequate enough to assure that information related to compliance with applicable laws will come to the board's attention in a timely manner.

Having implemented a compliance program, the director is charged with the responsibility of monitoring or overseeing the program's operations. Although monitoring the operation of an effective compliance program may seem like an insurmountable task, directors are permitted to rely on the officers and advisors in conducting their oversight responsibilities. The Office of Inspector General of Health and Human Services (OIG-HHS) has stated that crucial to the oversight function is the "fundamental principle" that a director is entitled to rely, in good faith, on officers, employees, and corporate advisors.[4]

It is also essential that the board exercise its oversight duties in good faith. The good faith analysis "usually focuses upon whether the matter or transaction at hand involves any improper financial benefit to an individual, and/or whether any intent exists to take advantage of the corporation."[5] Furthermore, board member's reliance on officers, employees, and corporate advisors may not be viewed in good faith if the board member is aware of facts suggesting that such reliance is unwarranted.[6]

The duty of care requires directors to be aware of what is occurring within the organization, and they must, in certain circumstances, make a reasonable inquiry as would an ordinary, prudent person under similar circumstances. However, OIG-HHS recognizes that the directors need not act as constant investigators in properly exercising their oversight duties. Specifically, it has pointed to the fact that the duty-of-care test involving reasonable inquiry has "not been interpreted to require the director to exercise 'proactive vigilance' or to 'ferret out' corporate wrongdoing."[7] Rather, the duty of care arises when a red flag is raised or suspicions are or

should be aroused and the board member should have known of the improper activity. "Absent the presence of suspicious conduct or events, directors are entitled to rely on the senior leadership team in the performance of its duties," according to the OIG-HHS. Therefore, a director will only have violated his duty of care if he fails to act after he has information that causes some concern and/or fails to request appropriate information from senior leadership about the organization's response and the effectiveness of its compliance program.

The existence of an effective corporate compliance program is key to ensuring board members are actively fulfilling their duty of care within the organization.

Practical guidance on board member responsibilities

In conjunction with a variety of other healthcare organizations, the OIG-HHS has published practical guidance that is intended to specifically assist governing boards of healthcare organizations in carrying out their compliance plan oversight obligations under applicable laws.[8]

The OIG-HHS encourages boards to use widely recognized public compliance resources as benchmarks for their organizations. These resources include the United States Sentencing Commission's Guidelines for Organizations (USSG), OIG-HHS' voluntary compliance program guidance documents available on its website, and OIG-HHS corporate integrity agreements (CIAs).

One of the best resources for ensuring that a corporation possesses an effective compliance program is contemplated in the USSG. These Guidelines are important to federal prosecutors and regulators in determining whether a company should be charged with a crime at the conclusion of an investigation. The USSG specify that an organization's exercise of due diligence to prevent unlawful activity and its promotion of an organizational culture that encourages ethical conduct and commitment to compliance with the law is essential to an effective compliance program.[9] Additionally, the USSG sets forth minimal standards that directors should implement to achieve due diligence and effective promotion. These standards include:

- That directors are knowledgeable about the content and operation of the compliance program and execute reasonable oversight with respect to its implementation and effectiveness;
- High-level management of the organization must ensure that the organization has an effective compliance program and shall be charged with overall responsibility over the program;
- The delegation to a compliance officer for day-to-day operational responsibility for the program and the provision of adequate resources to carry out its purpose;
- Use of reasonable efforts to exclude individuals from positions of authority who have engaged in activities inconsistent with an effective compliance program;
- That the compliance program's standards and procedures are communicated in a practical manner by conducting effective training and taking reasonable steps to monitor and audit the compliance program to evaluate its effectiveness; and
- The promotion and enforcement of appropriate incentives to perform in accordance with the program and to provide appropriate disciplinary measures for individuals engaging in criminal conduct, taking reasonable steps to respond to such conduct appropriately.[10]

A compliance program is not a "one size fits all" and the OIG-HHS expects boards

to put forth meaningful effort to review the adequacy of existing compliance systems and functions.[11] Directors should consider the size and complexity of their organizations in applying these compliance standards. The USSG recognize that boards of smaller organizations may need to become more involved in the organization's compliance and ethics efforts than larger organizations. A board of a healthcare organization can benefit from the appointment of a consulting expert to assist in addressing complex compliance issues.

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Additionally, OIG-HHS has provided insight on issues relating to a board's oversight and reviews of compliance program functions that it believes are necessary to maintain an effective compliance program. The OIG-HHS focuses its efforts in providing and calling upon directors to ask certain questions and implement its suggestions pertaining to four areas.[12]

1. Roles and relationships should remain separate

To ensure effective operation, organizations should define the interrelationship of the numerous functions applicable to board oversight. These functions may include the Compliance, Legal, Internal Audit, or Human Resources functions of the organization. To mitigate potential risks, organizations should apportion these functions between several individuals and provide individuals serving in multiple roles the capability to execute each function in an independent manner when necessary. Importantly, an organization's counsel and compliance officer should be two completely independent and separate individuals. The board must also understand how management approaches disagreements with respect to the resolution of compliance issues.

2. The board must be informed

Is the board receiving regular reports regarding the organization's risk mitigation and compliance efforts? Develop expectations for members of the management team and hold them accountable for performing in accordance with those expectations. Boards should consider establishing a risk-based reporting system and be assured that the mechanisms in place promptly inform the board of suspected violations to evaluate potential remedial measures. The OIG-HHS also suggests holding regular "executive sessions" with leadership from various company departments.

3. Monitoring potential risk areas

Are there adequate processes in place for identifying risk areas? When problems are publicized in similar corporations, the board should speak with management to determine whether there are processes in place to reduce the risks of similar misconduct. Is the board monitoring risk areas and implementing corrective action plans? Be aware of industry trends and review provider-physician relationships for compliance with the laws. Avoid compliance committee conflicts of interest (i.e., physicians may be faced with an issue that requires the physician to self-report).

4. Encouraging accountability and compliance

Assess employee performance in promoting and adhering to compliance. Ask management about efforts to develop compliance policies.

Being a proactive organization will realize long-term benefits if compliance issues arise.

The success of a compliance program also depends on the employees' ability to report problems when they identify the occurrence of non-compliant conduct. The board's duty of care requires that it explore whether responsive procedures are in place when the organization is presented with credible allegations of misconduct and whether disciplinary measures are enforced consistently.

One of the most important aspects of an effective compliance program is to promote and enforce a system that provides for mechanisms that allow for anonymity or confidentiality, whereby the organization's employees can report non-compliant activity and seek guidance regarding potential or actual non-compliant conduct without the fear of retaliation. Whistleblower protection from retaliation has become so important that a variety of federal laws now prohibit organizations from engaging in retaliatory conduct and provide the injured individual with a cause of action against the offending organization.[13] In fact, the OIG-HHS has recognized that in its fulfilment of its duty of care, the board should determine that the organization has a process in place to encourage this type of communication.

Although the design of an effective compliance program should not be a "one size fits all" approach, the OIG-HHS's guidance for healthcare governing boards provides a good measuring point for organizations that desire to implement a robust and effective compliance program.

Individual liability

Absent fraud, bad faith, or self-dealing, board members generally face limited individual exposure for failing to exercise their duty of care.

Many courts apply the "business judgment rule" to determine whether a director's duty of care has been met with respect to corporate decisions. The business judgment rule protects directors from liability when they make a decision in good faith and act as a reasonable, prudent person would have acted under the circumstances. The breadth of the business judgment rule usually protects directors from personal liability pertaining to allegations arising from a breach of the duty of care with respect to the exercise of judgment (e.g., an actual decision or vote of a director). Notably, it does not necessarily extend to the exercise of oversight of a director.

In the context of director oversight, good faith is measured by the directors' actions to assure that reasonable information and reporting systems exist. To impose individual liability for breach of the duty to monitor, the director must utterly fail to implement any reporting or information system or control. If such a compliance system has been implemented, the director must consciously fail to oversee its operations. Moreover, there must be a showing that the directors knew that they were not discharging their fiduciary obligations. As the court in *Stone* made clear, individual liability may be assessed "where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities."[14] Thus, a board's failure to implement a compliance program will not only put the organization at risk for liability, but it may also create individual board member liability in certain circumstances.

As identified in the section above, whistleblower retaliation protection is essential to an effective compliance program. An organization that retaliates against an employee for engaging in whistleblower activities may be liable to that individual for reinstatement with back pay and benefits, front pay, compensatory damages, and litigation costs, including attorneys' fees. Although there has been scant case

law to address whether this same standard for individual liability will expand to situations where corporate directors have engaged in retaliatory conduct, the recent decision in *Wadler* has expanded the scope of individual director liability for such acts under the "retaliation" circumstances described in that case.

The *Wadler v. Bio-Rad Laboratories, Inc.* decision

In October 2015, the United States District Court for the Northern District of California decided a case where Sanford S. Wadler, an individual, brought a whistleblower action against his former employer, Bio-Rad Laboratories, Inc., (Bio-Rad). The complaint also named the individual members of Bio-Rad's Board of Directors, contending wrongful termination in retaliation for investigating and reporting to Bio-Rad's upper-level management possible violations of the Foreign Corrupt Practices Act (FCPA) in China.

Mr. Wadler became Bio-Rad's general counsel in 1989 and served in that position for nearly 25 years. In 2009, Bio-Rad's corporate officers became aware that a number of its employees and agents in Vietnam, Thailand, and Russia may have violated provisions of the FCPA. Amid the allegations, Bio-Rad hired a law firm to investigate whether Bio-Rad employees were engaging in bribery in China. The law firm eventually concluded that there was no evidence of improper payments.

Thereafter, in 2012, Mr. Wadler uncovered evidence of potential bribery by Bio-Rad in China. He alleged that the CEO, CFO, and other members of management repeatedly ignored him and his investigation, so he eventually took his concerns to the board of directors. Bio-Rad hired the same law firm to conduct an investigation into Wadler's claims, and again, the law firm concluded that there was no evidence of FCPA violations. Mr. Wadler challenged this conclusion in light of his assertion that he found documents showing that Bio-Rad distributors engaged in unlawful practices in China. Additionally, the company later admitted publicly that it was, in fact, engaging in some of the very misconduct Mr. Wadler had complained about. Soon after, he was terminated.

Bio-Rad was a closely held, family-owned corporation. Norman Schwartz, the son of the founder, was the CEO and Chairman of the Board. Norman's mother, Alice Schwartz also served on the board. A significant decision within the corporation could not have been made without the Schwartz family's approval, because the actual voting control of Bio-Rad was held by the Schwartz family. Mr. Wadler alleged that the CEO effectuated his termination, but the decision to terminate him was made by a vote of the entire board. Mr. Wadler further contended that he was terminated because he reported his concerns "up the ladder" when it became clear that the company was not taking reasonable steps to investigate and remedy FCPA violations.

Mr. Wadler brought suit against the members of the Bio-Rad Board of Directors individually and the company itself, alleging, among other things, that he was terminated for engaging in protected activity under Sarbanes-Oxley (SOX) and the Dodd-Frank Act. Bio-Rad sought to dismiss Wadler's claims by arguing that neither SOX nor Dodd-Frank permits suits against individual directors. Mr. Wadler rejected this assertion and argued that the anti-retaliation provisions of SOX imposed liability on the directors as "agents" of Bio-Rad who retaliated against whistleblowers. Additionally, Mr. Wadler contended that individual directors may be liable as "employers" who retaliate against whistleblowers under Dodd-Frank.

The Court recognized that it was a "close call," and no case addressed the prospect of imputing individual liability on a director under either SOX or Dodd-Frank. Ultimately,

the court held that Mr. Wadler may proceed with his claims against the individual board members under both statutes.

In construing the term "agent" as used in SOX, the Court concluded the context and general purpose of SOX supported the conclusion that the term was intended to encompass directors. The Court found that the purpose of SOX would be significantly undermined if the term "agents" excluded directors. Such an interpretation would permit a corporation's board members to fire high-level employees for whistleblowing without liability, even though the exact same conduct on the part of the corporation's managers would give rise to individual liability. The Court further concluded that Congress intended to impose individual liability on those who have the *functional* ability to retaliate against whistle blowers, whether as a board member or a manager. Consequently, the Court concluded that directors may be individually liable as an "agent" under the retaliation protections of SOX.

The Court went on to hold that the term "employer" as used in the Dodd-Frank Act also permitted Mr. Wadler to bring claims of individual liability against the directors. The Court reviewed the legislative history of the Act and found that there was nothing to suggest that Congress intended to eliminate individual liability for those who retaliated against whistleblowers. It noted that the purpose of Dodd-Frank was to enact more stringent measures than were contained in SOX to protect whistleblowers, and therefore, individual liability is at least as extensive as that of SOX.

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Impact of the *Wadler* decision

A few important points can be gleaned from the *Wadler* decision.

The protection of individuals who bring non-compliant or unlawful activity to the attention of management is essential to a well-functioning and efficient compliance program. The *Wadler* decision suggests that courts are more likely to construe statutory provisions and hold directors individually liable for personally engaging in retaliatory conduct, a highly-protected activity.

The importance that SOX and Dodd-Frank place on whistleblower protection served as the linchpin for the Court's analysis of whether to impute individual liability on the directors for engaging in retaliatory conduct. As the Court recognized in its decision, portions of the legislative history underlying SOX and Dodd-Frank referred to the protection of whistleblowers as one of the main purposes of the bill. The Court left open the question of whether it would have reached the same decision if the action was brought under a different federal statute that did not emphasize such important protection for whistleblowers.

The *Wadler* case also highlights why organizations should avoid conflicts of interest. As discussed above, Bio-Rad was a closely held, family-owned corporation where family members served as both officers and directors. The Schwartz family owned the voting control over the board and no significant organizational decision could be made without the family's involvement. The effectiveness of a corporate compliance program under such circumstances can be significantly compromised when the

organization is faced with an issue that requires self-reporting, and it fails to act because of a conflict of interest. The governance realities of Bio-Rad required the Schwartz family members to approve reporting the occurrence of unlawful activity. Compliance programs should be designed in such a way to avoid conflicts of interest that limit their effectiveness.

Additionally, one could argue that the Court really held the board members individually liable as managers of the organization, rather than as directors, because they were acting in a managerial capacity by personally terminating Mr. Wadler. The reasonable, prudent person standard was not involved here to the extent the board members of Bio-Rad acted as true board members, but instead, they acted as owners and managers in effecting the termination decision, which is typically a management responsibility. This interchangeability disabled the purpose of individuals holding separate and distinct roles within the organization.

Conclusion

Overall, it remains to be seen how other courts will apply the *Wadler* decision, and whether courts will extend its holding to other federal laws such as the False Claims Act. Regardless of future application, directors should be made aware of just how important exercising the oversight function of their duty of care is to establish an adequate compliance program and ensure its effective operation.

1. *Wadler v. Bio-Rad Lab., Inc., et al.*, 2015 WL 6438670 (N.D. Cal. Oct. 23, 2015). Available at http://bit.ly/1S03E7B
2. In re *Caremark Intern, Inc. Derivative Litigation*, 698 A.2d 959 (DE. Ch. 1996) and *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362 (DE. 2006).
3. HHS-OIG and the American Health Lawyers Association: *The Health Care Director's Compliance Duties: A Continued Focus of Attention and Enforcement* (2011). Available at http://1.usa.gov/1SSWm5S
4. *Id*. at page 6
5. *Id*. at page 5
6. *Id*. at page 6
7. *Id*.
8. HHS-OIG, et al.: *Practical Guidance for Health Care Governing Boards on Compliance Oversight* (2015). Available at http://1.usa.gov/1J5dqmf
9. U.S. Sentencing Commission: *Guidelines Manual* § 8B2.1(a). Available at http://bit.ly/1VB9eQk
10. *Id*.
11. OIG et al., *supra* note 8.
12. *Id*. at pages 6-15.
13. *See e.g.*, 31 U.S.C. § 3730(h); 18 U.S.C. § 1514A(a)(1)(C).
14. Ibid Ref #2, *Stone*, 911 A.2d at 370.