Revisiting the Board’s Compliance Oversight Obligations

Health Care Compliance Association Audit Committee Conference

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WELCOME;  
NOTE HANDOUT
Where We’re Going This Morning
A Fiduciary Duty-Directed Presentation, with Specific Focus on the Board’s “Caremark” Obligations As A Manifestation of the Duty of Care.
Key Point: This Will be a “Glass Half Full” Presentation: Educational and Presenting Opportunities, Not Threatening.
How We’ll Get There
By looking at:

1. Core Duty of Care Requirements
2. Amendments to the Federal Sentencing Guidelines
3. Comments of the Office of Inspector General
4. Recent Case Law
5. The Perspective of the Department of Justice
6. Relevant Observations of SEC Officials
All for the Principal Goal of Assisting the Governing Board in Exercising its Basic Duty to Provide Compliance Plan Oversight
But, Before We Begin . . .
A Few Basic Observations
First, The Screen Through Which We’re Looking at Corporate Compliance Today
Second, An Awareness of the Continuing Sarbanes/Oxley Spillover into All Aspects of the Health Care Industry-Including Insurance Plans
Third, An Understanding that Basic Compliance Issues, and Related Board Oversight, Know No Entity Barriers
Fourth, Case Law Notwithstanding, Regulators Are Increasingly Willing to Call Director Conduct Into Question—So Manifestation of Good Faith is KEY
So, Let’s Get Going!
Part I

Caremark and the Director’s Compliance Oversight Obligation
The Duty of Care (In Review): Requires a Director to Act in Good Faith with the Care an “Ordinarily Prudent Person” Would Exercise Under Similar Circumstances
Disney and the Business Judgment Rule
The Duty of Care Arises in Two Distinct Contexts:
The *decision-making function*: The application of duty of care principles to a specific decision or board action; and
The *oversight function*: The application of duty of care principles with respect to the general activity of the board in overseeing the day-to-day business operations of the corporation.
i.e., the exercise of reasonable care to assure that corporate executives carry out their management responsibilities and comply with the law.
Directors’ obligations with respect to corporate compliance programs arise within the context of the oversight function.
A Little Background on *Caremark* . . .
Caremark provides that a director has two principal obligations with respect to the compliance oversight function. The director has a duty to attempt in good faith to assure that:
1. A corporate information and reporting system exists; and

2. This system is adequate to assure the board that appropriate compliance-related information will come to its attention in a timely manner in ordinary course.
*Caremark* addressed the circumstances in which directors could be held liable for fiduciary breach for failing to supervise employees whose conduct created legal jeopardy for the corporation.
Level of detail for such system a matter of business judgment
No system is fool-proof
Acceptable to rely in good faith on officers, advisors, etc.
- No obligation to exercise “proactive vigilance”
- Duty to make reasonable inquiry increases when “suspicions are aroused or should be aroused”
- Once presented with concerns, duty to make further inquiry
Stone v. Ritter
The Latest Word on Caremark—a “Disney” Twist
Case Confirms Caremark Principles for Liability

That 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.”
In the absence of “red flags,” good faith must be measured by the directors’ actions to assure that a reasonable corporate compliance plan exists, and not by “second guessing” director conduct.
Unique Industry Challenges
The Open Issue: Caremark establishes a board’s duty to oversee a compliance program, but does not enumerate a specific methodology for doing so. That’s the challenge confronting Boards.
Assisting the Board in Exercising that Oversight Obligation: Thoughts on Specific Methodology
A Primary Resource: The Two Educational Guides Published Jointly by the Office of Inspector General (HHS) and the American Health Lawyers Association.

“Corporate Responsibility . . .”

- *Structural questions* exploring board’s understanding of the scope of the organization’s program
- *Operational questions* facilitating board’s understanding of the vitality of the organization’s program
“An Integrated Approach . . .”

- Board role in assuring GC/CCO coordination
- Questions re: board’s understanding of roles of GC and CCO assuring board receives appropriate program information in a timely manner
The Impact of the Amended Federal Sentencing Guidelines
Quick Background: The Role of the Sentencing Guidelines and their Relationship to Corporate Compliance Plans.
The 2004 Amendments are intended in part to:

- Emphasize the importance of compliance programs and provide more prominent guidance on the attributes of such programs;
- Add more detail to the seven steps for an “effective” compliance program (introducing additional rigor, generally); and
Impose significantly greater responsibilities on the organization’s governing board (and executive leadership) regarding satisfaction of the “Effectiveness” criteria.
The 2004 Amendments include two specific changes which relate directly to governing board oversight obligations:
First, the Amendments add a requirement that the organization shall *promote an organizational culture that encourages a commitment to compliance with the law.*
This requirement is intended to reflect the “emphasis on ethics and values” incorporated within Sarbanes-Oxley and other “corporate responsibility” initiatives.
Second, the Amendments require the Board to:

- Be knowledgeable about program content and operation; and
- Exercise reasonable oversight of its implementation and effectiveness.
Part IV

The Impact of the New DOJ Corporate Prosecution Guidelines (a/k/a “McNulty” Memorandum)
Quick Background: The “McNulty Memorandum” sets forth the principles to guide DOJ in making decisions re: charges against a business organization.
Note: The Presence of a Corporate Compliance Program is a Factor Considered in the Guidelines . . . Yet:
The existence of a program is not sufficient, in and of itself, to justify not charging a corporation for conduct undertaken by its officers, directors, employees or agents.
Indeed, violations of law in the face of a compliance program may suggest that executive management is not adequately enforcing its program.
The DOJ Focus:

1. Is the compliance program well designed?
2. Does the program work, or is management tacitly encouraging employees to engage in misconduct to achieve business objectives?
Factors in the Evaluation:
1. Comprehensiveness of program
2. Extent and pervasiveness of illegal activity
3. Number and level of employees involved
4. The seriousness, duration and frequency of misconduct
5. Remedial actions taken by the corporation (e.g., restitution, disciplinary action, revisions to compliance program)
6. Promptness of disclosure to government
7. Whether program mechanisms are effective in detecting and preventing misconduct
8. With respect to Governing Board:
   • Exercise of independent review
   • Provided with information supporting independent judgment
   • Effective internal audit functions
   • Effective internal reporting system
Key DOJ Questions:

1. Is the Corporate Compliance Program “Effective” or Merely a “Paper Program”?
2. Is there adequate program staff to audit, document, analyze and utilize the results of the corporation’s compliance plan efforts?
3. Are the corporation’s employees *adequately informed* about the compliance program and *convinced* of the corporation’s commitment to the program?
See Attached Chart
Part V

The Perspective of the SEC
Relevance to Nonprofits:
- Responsible for Sarbanes/Oxley Rulemaking
- Influence of Steps to Emphasize Corporate Compliance
- Policy Example of “Culture of Compliance”
- Policy Example of New Statement on Corporate Penalties
- Trying to induce companies to address “tone and culture”
- Speaking to the “fundamentally honest, decent” CEO or CFO or GC
- Go beyond what an enforcement action might compel you to do
“Talking the Talk”

- Every employee should know company commitment to ethics
- Standards must “infuse day-to-day lives”
- Embrace “real life” situations and dialogue
- Executive remarks should balance values and profits
- No hidden messages (e.g., “results at any cost”)
- Senior management must do the talking
- No “double talk” or “offline” contradictions
- Extend the “talk” outside company walls (e.g., vendors, consultants, contractors)
- Speaking and listening in equal parts
- Empower “reporting up”
“Walking the Walk”

- Managers themselves must comply with rules; employees watch what managers do and say
- Make “character” a part of key hiring criteria
• Make integrity, ethics and compliance part of the promotion, compensation and evaluative processes
• Make it clear leadership won’t tolerate compliance violations
- Hold managers accountable for setting right-tone
- Monitor, follow-up and re-assess; sustained effort
Part VI

Observations and Conclusion
1. The Board’s *Caremark* obligation is clear
2. The methodology to apply in order to satisfy those obligations is similarly clear
3. It is useful to evaluate satisfaction of the obligation through a broad perspective that reflects the fundamentals of corporate responsibility
4. There is a consistency of themes from the various perspectives:
   • Board Awareness of the Program
   • “Tone at the Top”/“Culture of Compliance”
   • “Walking the Walk”/Commitment to Resources
   • Plan Substance/No “Paper Program”
In the End, a “Good News” Message: An Achievable and Sustainable Duty Which Clearly Serves the Corporate Interest