

Understanding Your Board's Compliance Oversight Role

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What We'll Cover Today

- Board's Role and Fiduciary Duties
- Duty of Care Challenges
- What Boards Can Do to Protect Themselves and Their Organizations

The Board's Fiduciary Duties

Board's Role Generally

- Responsible for management, finances, and other affairs of the corporation
 - Supervision and governance of the organization's efforts in carrying out its mission
 - NOT required to manage the day to day activities of the organization (may delegate to officers and employ individuals who carry out the daily tasks of running the organization)
 - Must be active, informed, and engaged as Directors are considered fiduciaries (i.e., they are in a position of trust vis a vis the organization.)
- Specifically, directors are subject to the fiduciary duties of care, loyalty and obedience

Duty of Care

The Duty of Care generally requires that directors discharge their duties in good faith, in a manner the director reasonably believes to be in the best interests of the organization, and with the care an ordinary prudent person in a like position would exercise under similar circumstances.

What Does the Duty of Care Generally Require?

1. **Actively Participate.** Prepare for and attending board meetings, read and evaluate materials received in advance of meetings, read meeting minutes, review financial performance, strategy.
2. **Be Informed and Exercise Independent Judgment.** A director must take the time to become informed and base decision on their own judgment. Ask questions as needed. Independently evaluate positions of other board members, executive staff, outside experts. Create a record of decision making processes (minutes). Promote and participate in active/open discussions.

What Does the Duty of Care Generally Allow?

- 1. Retention of and Reliance on Management, Outside Experts.** Corporation law generally recognizes the Board member's right to rely on internal and outside experts (attorneys, accountants, consultants, appraisers) as long as the board member reasonably believes that the information and recommendations are reliable and competent.
- 2. Board Committees.** Board's may delegate some functions to board committees and, as above, Board Members may rely on the committee, as long as the board member reasonably believes the committee is reliable and competent.

Duty of Loyalty

The Duty of Loyalty is the Board member's obligation to act in the best interest of the organization, and not to use his or her authority to advance personal interests, or interests of related third parties (e.g., family members). Self-interests may be financial, but may also include things like enhancing prestige or professional reputation.

What May Violate the Duty of Loyalty?

1. **Failure to Properly Manage Conflicts of Interest.** Where a board member has a conflict (e.g., owns an interest a law firm representing the organization), proper management of the conflict generally requires full disclosure, approval by disinterested directors (only), and a fair deal for the organization.
2. **Self-Dealing.** Approving a transaction in which the director has a self-interest (e.g., a stock option plan), or usurping an organizational opportunity (e.g., buying land that the director knows is sought by the organization) might both violate the duty of care.

Duty of Obedience

This is the duty to follow the purpose and goals as set out in the organization's articles, bylaws, purpose and mission statement. This duty is particularly important in nonprofit organizations as the organization's nonprofit status is generally dependent on adherence to the nonprofit purpose for which it was organized. This duty would also include a duty to assure fidelity to the terms of gifts, grants and bequests. Some states also specify that this duty includes a duty to assure compliance with the law.

Who Can Enforce Fiduciary Duties (Who Can Sue a Board or Board Member?)

- **Insiders** (current and former employees, for all variety of work-related offenses including ADA violations, sexual harassment occurring at work, discrimination, wrongful termination, etc.)
- **Outsiders** (for harm caused by the organization – shareholders (derivative suits), donors, vendors, creditors, etc.)
- **The Organization Itself** can sue current and former directors for violation of fiduciary duties.
- **Directors** one director may sue another for violation of fiduciary duties (in some cases State laws require this)
- **Members** (in membership organizations, associations, etc.)
- **State's Attorneys General** (represents the interests of the public in proper operation of nonprofit and public organizations)
- **Other Governmental Officials** (e.g., US Department of Labor, Internal Revenue Service (see IRC §4958 re: Excess Benefit Transactions (board members who approve can be fined 10% up to \$10,000); and IRC §6672 and *Verret v. United States*, 542 F. Supp. 2d 526 (E.D. Tex 2008) (found board chairman liable for \$400K in withholding taxes not paid by a nonprofit hospital)

Duty of Care Challenges

In re Caremark

Directors' duty of care includes a duty to attempt in good faith to assure that:

1. A corporate information and reporting system exists, and
2. The reporting system is adequate to assure the board that appropriate compliance-related information will come to its attention in a timely manner, in ordinary course.

In re Caremark International Inc. Derivative Litigation, 698 A.2d 959 (Del. 1996)

Stone v. Ritter

"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 information and reporting system exists."

To prevail on a breach of the "duty to monitor" a plaintiff must show either that

- (a) the directors utterly failed to implement any reporting or information system or controls, or else
- (b) having implemented such a system or controls, [the directors] consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.

Scienter Element: "[i]n either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations," that is, that they were "demonstrating a conscious disregard for their responsibilities."

Stone v. Ritter, 911 A2d 362, 370 (Del. 2006)

Lemington Home

In re Lemington Home for the Aged, 777 F.3d 620 (3d Cir. 2015)

The Lemington Story – Nonprofit nursing home and prolonged financial difficulties

- **CEO:** Paid full-time, worked part-time. Blamed for significant repeated deficiencies (e.g., failure to maintain medical records, excess patient deaths and survey deficiencies.)
- **CFO:** Didn't keep a general ledger and failed to collect \$500K from Medicare
- **Board:** failed to uphold duties of care and loyalty. Failed to hire competent executives; failed to supervise and remove incompetent executives; did not maintain regular meetings or keep regular minutes; failed to create a finance committee; ignored financial problems; deferred filing for bankruptcy; failed to establish a reasonable sale plan.

Lemington Home

In re Lemington Home for the Aged, 777 F.3d 620 (3d Cir. 2015)

- Lemington directors and officers are sued by creditors
- Court awards \$2.25 Million in compensatory damages, and punitive damages of \$1M against the administrator, and \$750K against the CFO (upheld by the 3rd Circuit Court of Appeals)
- NOT covered by the business judgment rule nor by D&O Insurance

Wells Fargo – alleged “red flags”

- Cross-selling strategy featured in annual reports beginning 2006
- “GR-Eight Initiative” (strict quotas regulating the number of products Wells Fargo bankers must sell – 15 new accounts per day)
- 2007 Letter to Stumpf (CEO) and Board Audit & Examination Committee from employee detailing unethical and illegal activity resulting from GR-Eight Initiative
- Ethics Line reports presented to Board Audit & Examination Committee from at least 2011 forward showed increases in sales integrity issues or notifications to law enforcement related to sales integrity issues
- Successful qui tam by former employee in 2008, and increasing litigation from 2008 to 2013 involving fake accounts
- Communication to Stumpf and HR Execs in 2011 from branches in New Jersey and Arizona re: employees creating fake accounts

Wells Fargo – alleged “red flags”

- LA Times article in December 2013 reporting unauthorized accounts and credit cards to meet quotas (discussed at Board meeting)
- Former employee communications to Stumpf and the Board beginning in April 2015 (with repeat follow ups)
- LA City Attorney investigation and resulting litigation resulting from LA Times articles
- Office of the Comptroller of the Currency (“OCC”) supervisory letters (re Wells Fargo risk management) detailing Matters Requiring Attention “MRAs” related to aggressive sales practices
- September 2016 Consent Orders from LA City Attorney, US Consumer Financial Protection Bureau and OCC.
- September 2016 Congressional investigatoin

Wells Fargo – motion to dismiss denied

“To prevail . . . Plaintiffs ‘must show that the directors knew they were not discharging their fiduciary obligations or that the directors demonstrated a conscious disregard for their responsibilities’ . . . The extensive and detailed allegations in the complaint plausibly suggest that a majority of the Director Defendants did precisely that.”

Shaeo ex rel. Wells Fargo & Co. v. Baker et al, December 12, 2016, N.D. Cali.

Freeh Report (Penn State)

- Citing *Stone v. Ritter*, Special Counsel found that the Board failed in its fiduciary duties because:
 - In 1998 and 2001 the Board did not have regular *reporting procedures or committee structures* in place to ensure disclosure to the Board of major risks; and
 - In 2011 because, after becoming aware of the Grand Jury investigation of Sandusky, Board members did not independently assess the information provided by Spanier (President) and Baldwin (General Counsel) or demand detailed reporting from the same.
 - The Board failed to create a “Tone at the Top” environment that Sandusky and other University officials believed they were accountable to.
 - The Board’s failure to insist on thorough reporting led to an environment where President Spanier did not feel accountable for keeping the Board immediately informed on serious developments.
 - “The Board allowed itself to be marginalized by not demanding ‘thorough and forthright reports on affairs of the University’

How Can Board's Protect the Organization and Themselves?



Corporate Integrity Agreement – Board Resolution

The Board of Directors has made a reasonable inquiry into the operations of [Organization's] Compliance Program including the performance of the Compliance Officer and the Compliance Committee. Based on its inquiry and review, the Board has concluded that, to the best of its knowledge, [Organization] has implemented an effective Compliance Program to meet Federal health care program requirements and the obligations of the CIA.

DOJ Effectiveness Document

- What compliance expertise has been available on the board of directors?
- Have the board of directors and/or external auditors held executive or private sessions with the compliance and control functions?
- What types of information have the board of directors and senior management examined in their exercise of oversight in the area in which the misconduct occurred?
- Have the compliance and relevant control functions had direct reporting lines to anyone on the board of directors?


Additional Strategies for the Board

- Monitor things in a different way
- D&O Insurance
- Materials used for the HCCA/SCCE Board Conference.

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2019

Board & Audit Committee Compliance Conference | February 18 – 19, 2019 | Scottsdale, AZ

2018

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2017

Board Audit Committee Compliance Conference | February 27 – 28, 2017 | Scottsdale, AZ

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Questions & Discussion

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