

Effective Third Party Due Diligence for Compliance

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Today's Focus: Big Picture AND In the Weeds

- Big Picture
 - Third-party management cycle and process
 - Key considerations in each phase
- Drill down into three specific issues
 - Guidance focused on three components of third party management



Scope of Third Parties


- Suppliers/vendors
- Service providers
- Subcontractors
- Distributors
- Agents
- Intermediaries
- Joint venture partners
- M&A targets



**THE IMPORTANCE OF THIRD-PARTY
DUE DILIGENCE**


*EVALUATION OF CORPORATE
COMPLIANCE PROGRAMS*

United States Department of Justice – Fraud Section
February 2017
Eleven areas to be evaluated, including:
No. 10 – Third Party Management
No. 11 – Mergers and Acquisitions




Third-Party Management (U.S. DoJ)

- Risk-Based and Integrated Processes
 - How has the company's third-party management process corresponded to the nature and level of the enterprise risk identified by the company?
 - How has this process been integrated into the relevant procurement and vendor management processes?
- Appropriate Controls
 - What was the business rationale for the use of the third parties in question?
 - What mechanisms have existed to ensure that the contract terms specifically described the services to be performed, that the payment terms are appropriate, that the described contractual work is performed, and that compensation is commensurate with the services rendered?




Third-Party Management (U.S. DoJ)

- Management of Relationships
 - How has the company considered and analyzed the third party's incentive model against compliance risks?
 - How has the company monitored the third parties in question?
 - How has the company trained the relationship managers about what the compliance risks are and how to manage them?
 - How has the company incentivized compliance and ethical behavior by third parties?
- Real Actions and Consequences
 - Were red flags identified from the due diligence of the third parties involved in the misconduct and how were they resolved?
 - Has a similar third party been suspended, terminated, or audited as a result of compliance issues?
 - How has the company monitored these actions (e.g. ensuring the vendor is not used again in case of termination)?




Mergers and Acquisitions (U.S. DoJ)

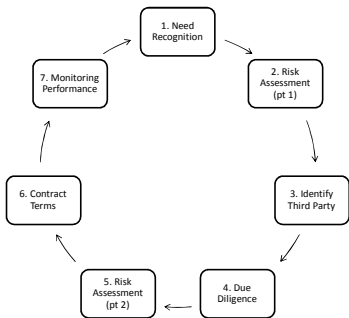
- Due Diligence Process
 - Was the misconduct or the risk of misconduct identified during due diligence?
 - Who conducted the risk review for the acquired/merged entities and how was it done?
 - What has been the M&A due diligence process generally?
- Integration in the M&A Process
 - How has the compliance function been integrated into the merger, acquisition, and integration process?
- Process Connecting Due Diligence to Implementation
 - What has been the company's process for tracking and remediating misconduct or misconduct risks identified during the due diligence process?
 - What has been the company's process for implementing compliance policies and procedures at new entities?




A FRAMEWORK FOR EVALUATING YOUR THIRD PARTY MANAGEMENT FUNCTION



Third-Party Management Life Cycle




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graph TD; 1[1. Need Recognition] --> 2[2. Risk Assessment (pt 1)]; 2 --> 3[3. Identify Third Party]; 3 --> 4[4. Due Diligence]; 4 --> 5[5. Risk Assessment (pt 2)]; 5 --> 6[6. Contract Terms]; 6 --> 7[7. Monitoring Performance]; 7 --> 1;
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Phases/Questions

1. Need recognition


- Is there a legitimate business need for a third party?
- What business purpose would the third party serve?
- Can we clearly articulate the scope of what the third party will do?
 - Scope of work



Phases/Questions

2. Risk assessment (part 1)


- What risks have been identified with the use of a third party (in general) for this service, or for this type of relationship?
 - Not third-party-specific at this point (i.e. what are the risks of us outsourcing this function?)
 - Considerations to include:
 - Monetary value of contract/relationship
 - Nature/volume of data held or accessed by third party
 - Financial risks, handling of assets, etc
 - Type of relationship (acquisition, JV, vendor, etc)
 - Nature of services provided
 - Design of due diligence procedures to be applied to:
 - All initial third parties under consideration, or
 - Finalist(s) only



Phases/Questions

3. Identification of third party(ies)


- What process was used for identifying potential third parties that could fill our needs?
- How was the specific third party selected?
 - Or how did we narrow the list to finalists?
- What preliminary background checking steps have been performed, and what are the results?



Phases/Questions

4. Due diligence


- What process was used for determining level & type of due diligence required (based on types of risk, monetary amount, what else?)
- Which characteristics are important to vet?
- Documentation and retention
- Five levels:
 - I. Checking organization and individual names through watch lists, criminal databases, excluded parties lists, etc
 - II. Screening of media, more in-depth internet searches on company, key execs, closely related parties
 - III. Comprehensive background checks of key individuals, reference checking, etc
 - IV. Review of submitted documentation (licenses, financials, policies/procedures, etc)
 - V. Site visit to perform due diligence, inspections, test controls, processes, interviews, etc (always done for acquisitions, maybe for others)



Phases/Questions

5. Risk assessment (part 2)


- What unique risks have been identified with respect to this specific third party?
 - Based on due diligence (e.g. results of assessing third party's internal controls, etc)
- Match/map risks to:
 - Contract provisions, where applicable
 - Specific ongoing monitoring procedures to be performed during period of performance



Phases/Questions

6. Contract terms


- Is there a clearly stated scope of work?
- Are fees and payment terms clear and appropriate?
- Have we properly customized an audit rights clause?
- Have appropriate termination (and, if appropriate, penalty) provisions been included in the contract?




Phases/Questions

7. Monitoring during Period of Performance

- Do we have a plan or monitoring the third party?
- What monitoring techniques will we utilize?
 - Mapped to Part 1 and Part 2 risks
 - On-site vs. from our office
 - Doc review vs. analytics
- Who will be involved in monitoring?
 - Internal audit? Others?
 - Third parties?
- Process for escalating/terminating, etc if problems arise during monitoring




SPECIFIC ISSUES INVOLVING THIRD PARTY MANAGEMENT



ISSUE NO. 1

Vicarious Liability



Liability for Acts of Nonemployees

- A principal “can be liable for the torts of a nonemployee agent only if those actions are within actual or apparent authorization of the principal.”
- “A principal is vicariously liable for an act of its nonemployee agent only if the principal intended or authorized the result or the manner of performance of that act. Intention or authorization over the manner of performance must include the right to control the physical details of the conduct of the agent that gave rise to the tort claim.”
- *Thomas v. Oregon State Police*, 2013 U.S. Dist. LEXIS 90938 (Dist. Ore. 6/25/13)



10-factor test: Restatement of Agency

1. The extent of control exerted by the master/employer,
2. Whether the one employed is engaged in a distinct occupation,
3. Whether the work is normally done under the supervision of an employer,
4. The skill required,
5. Whether the employer supplies tools and instrumentalities [and the place of work],



10-factor test: Restatement of Agency

6. The length of time the person is employed,
7. Whether payment is by time or by the job,
8. Whether the work is in the regular business of the employer,
9. The subjective intent of the parties, and
10. Whether the principal/employer is or is not in a business



Jones v. Healthsouth Treasure Valley

- Hospital might be liable for the acts of an independent contractor if:
 - The hospital's conduct would lead a plaintiff to reasonably believe that another person acts on the hospital's behalf (i.e., the hospital held out that other person as the hospital's agent); and
 - The plaintiff reasonably believes that the putative agent's services are rendered on behalf of the hospital (i.e., the plaintiff is justified in believing that the actor is acting as the agent of the hospital).



"Apparent Authority" of Third Party

(Navo v. Bingham Memorial Hospital)

- The hospital contracted with the contractor to provide relevant services to hospital patients.
- The hospital represented that the contractor was the "manager" of the hospital service line.
- Hospital advertisements did not disclose that services were performed by independent contractors.
- The hospital's consent forms did not identify the contractor as an independent contractor or expressly disclaim liability for the contractor's services.
- The consent forms used by the contractor were on the hospital's letterhead.
- The hospital allowed the contractors to use hospital scrubs and name tags bearing the hospital's name.
- The hospital billed the patient for the services performed by the contractor




Other Factors to Consider

- Whether the hospital supplied or assigned the contractor.
- Whether the contractor's services are typically provided in and as part of the hospital's services, e.g., emergency room, anesthesiology, or radiology services.
- Whether there was notice to the patient that the contractor was independent of the hospital through, e.g., advertising, consent forms, badges, oral communications, etc.
- Whether patient selected the provider or had prior contact with practitioner.
- Whether patient had special knowledge of contractual relationship



ISSUE NO. 2

Public Records Searches in Due Diligence




Public Records Searches

- Trade and professional associations & industry sources
- Court records (criminal, civil, probate, bankruptcy, etc)
- Enforcement boards and sanctions
- Excluded Parties List System (SAM.gov)
- Social media
- County records (e.g. real estate, etc)
- Local/city records (e.g. business licenses, builders permits, etc)
- Public Record Retriever Network (www.prrn.us/Home.aspx)
- State agencies (e.g. business registration, etc)
- Google Maps




Alaska State Due Diligence

- Business entities:
 - www.commerce.state.ak.us/CBP/Main/SearchInfo.aspx
- Business licenses:
 - www.commerce.state.ak.us/CBP/Main/CBPLSearch.aspx?mode=BL
- Election campaign disclosure records:
 - <https://webapp.state.ak.us/apoc/searchcampaigndisclosure.jsp>
- Recorded documents:
 - www.dnr.alaska.gov/ssd/recoff/searchRO.cfm
- Sex offender registry:
 - www.dps.state.ak.us/sorweb/Search.aspx
- UCC:
 - www.dnr.alaska.gov/ssd/recoff/searchUCC.cfm




ISSUE NO. 3

Audit and Access to Records Clauses




Audits

- Financial vs. Compliance
 - With financial, focus is on billing
 - Compliance focuses on contract provisions, compliance with laws
 - Either can address processes, policies, etc
- Surprise vs. With Notification
 - Surprise is more likely to detect fraud, noncompliance, etc, but creates other problems and inefficiencies
- Our Staff vs. Third Parties
 - Expertise, availability, cost considerations



Audit Clauses

- Establishes right to perform an audit of a third party
- Customized terms, not boilerplate, for each scenario
- Key issues:
 - Audit vs. inspect, review, examine, etc
 - Type of audit (financial, compliance, other)
 - Audit period – how far back
 - Record retention (which records and for how long)
 - Access to, copies of, documents and records
 - Which ones?
 - Format of records
 - Planned (and notification) vs. surprise
 - Facilities, assistance, copying records, etc
 - Third party auditors? Who?
 - Application to subcontractors
 - Cost recovery, extrapolation, penalties, repayment, etc
 - Arbitration



Audit Clauses – Good or Bad?

“Upon reasonable notice, Clinic will have the right to audit books and records of Contractor to determine the accuracy of Contractor invoices at a time and date mutually agreeable to Clinic and Contractor.”



Audit Clauses – Good or Bad?

“Hospital shall have the right to inspect, with Contractor’s assistance and cooperation, Contractor’s books and financial records pertaining to the services Contractor provides for Hospital...”



Audit Clauses – Good or Bad?

“Contractor shall provide all necessary information in electronic form.”



Audit Clauses – Good or Bad?

“All audit work will be done on Contractor premises, and no Contractor documentation shall be removed from Contractor’s office. Contractor shall make personnel available to answer questions for the auditors.”



Audit Clauses – Good or Bad?


“Audits may be conducted only by independent third parties that are mutually acceptable to Hospital and Contractor.”



Audit and Monitoring Plans

- Risk-based plan customized for each third party
 - Many good techniques included in HCCA’s *Health Care Auditing & Monitoring Tools*
- Detailed plan describing:
 - Steps/techniques
 - Frequency
 - Approach to sample selection(s)
 - Responsibility
- Utilize forensic data analytics
 - Use multiple data sources to monitor for specific indicators
 - Multi-factor risk scoring vs. single-factor analytics
- Exercise audit rights clauses
 - When red flags arise
 - Periodically even when no red flags



<p>QUESTIONS ??</p> <p>Gerry.zack@corporatecompliance.org</p> 	
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