

*Board Oversight of
Compliance Programs:
What's Required and
How to Help Your
Board Succeed*



 **ARETE**
COMPLIANCE SOLUTIONS

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AGENDA

- Board Fiduciary Duties (Overview)
- History: Fiduciary Duties & Compliance Oversight
- Recent Delaware Cases
- Guidance: What is Required for a Board Member to be Effective in Compliance Program Oversight
- Ten Strategies to Helping Your Board Members Succeed

FIDUCIARY DUTIES OF A BOARD OF DIRECTORS

What is a fiduciary?

- A person who holds a legal or ethical relationship of trust with one or more other persons

Fiduciary Duties of a Board of Directors

DUTY OF CARE

- Generally, requires directors to act
 - in good faith
 - with the level of care that an ordinarily prudent person would exercise in like circumstances, and
 - in a manner that they reasonably believe is in the best interest of the corporation.

Fiduciary Duties of a Board of Directors

DUTY OF LOYALTY

- Requires a director to act in good faith and with the conscientiousness, fairness, morality and honesty that the law requires of fiduciaries
 - in the best interest of the company
 - generally, prohibits self-dealing transactions
 - more than just a prohibition against self-dealing: may require action

Fiduciary Duties of a Board of Directors

BUSINESS JUDGMENT RULE

- Courts generally will not hold a director liable for a decision made in good faith, where the director is disinterested, and rationally believes the decision to be in the best interests of the corporation.



HISTORY: DEVELOPMENT OF THE FIDUCIARY DUTIES IN DELAWARE COURTS



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Graham v. Allis-Chalmers

“Absent cause for suspicion [i.e. “red flags”] there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.”

Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del 1963)

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

To prevail on a breach of the *Caremark* “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)

Stone v. Ritter

A *Caremark* claim is a Duty of Loyalty claim based on a failure to act in good faith

“ . . . 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 duty of care.” (*Id.* 369)

“Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.” (*Id.* 369)

Difficulty of Pleading a Successful Caremark Claim

“It has become among the hoariest of Chancery clichés for an opinion to note that a derivative claim against a company’s directors, on the grounds that they have failed to comply with oversight duties under Caremark, is among the most difficult of claims in this Court to plead successfully.” (Chou at page 1)



RECENT DEVELOPMENTS IN *CAREMARK* CASES



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Recent Development in *Caremark* Cases

BUT, Since 2019 several *Caremark* cases have been allowed to survive motions to dismiss. Why?

- Not a change in the legal requirements
- Delaware General Corporate Law (DGCL) § 220 & recent case law clarifications about what can be sought.
 - Company Emails (*KT4 Partners LLC v. Paliantir Techs. Inc. (Del. Jan 29, 2019)*)
 - Personal Emails & Texts of Board Members (*Schnatter v. Papa John's Int'l, Inc. (Del. Ch. Jan 15, 2019)*)
- Multiple cases with bad facts/poor showings *vis-à-vis Caremark* and its progeny.
- Increase scrutiny on board oversight activities?

Marchand v. Barnhill et. al. Derivative Litigation 212 A.3d 805 (Del. June 18, 2019)

Based on “prong 1” of the Stone v. Ritter holding

“... the complaint supports an inference that no system of board-level compliance monitoring and reporting existed at Blue Bell ... the fact that Blue Bell nominally complied with FDA regulations does not imply that the *board* implemented a system to monitor food safety *at the board level*. (Motion to Dismiss denied)

- *NOTE: Blue Bell directors eventually settled for \$60M on April 27, 2020*

Clovis Oncology, Inc. Derivative Litigation (Del. Ch. October 1, 2019)

Based on “prong 2” of the Stone v. Ritter holding:

“plaintiffs have pled particularized facts to support a reasonable inference the Board Defendants face a substantial likelihood of liability . . .” (Motion to Dismiss denied)

Teamsters Local 443 Health Services Plan et.al v. Chou (“Amerisource” or “ABC”)

(Del. Ch. August 24, 2020)

- ABCs Audit Committee Charter charges it with “assist[ing] the [Board] with oversight of [ABC’s] compliance with legal and regulatory requirements . . .”
- The Audit Committee is responsible for reporting regularly to the Board
- Chief Compliance Officer and Chief Compliance Counsel charged with oversight of the Compliance Program

Amerisource

Board and Audit Committee Materials/Minutes were sought in Section 220 document request. The minutes and materials did not include clear documentation of follow-up on

- External compliance reviews (2)
- DOJ & FDA Subpoenas
- Qui tam complaint

Motion to Dismiss in denied

Amerisource

“...when a company operates in an environment where externally imposed regulations govern its ‘mission critical’ operations, the board’s oversight function must be more rigorously exercised.” Thus, when regulations governing drug health and safety are at issue, ABC’s Board must actively exercise its oversight duties in order to properly discharge its duties in good faith. (quoting Clovis)

In Re Boeing Company Derivative Litigation (Del. Ch. Sept 7, 2021)

- Opinion outlines a cultural shift from “safety to profits first.”
- No Board level process to oversee airplane safety (primarily focused on financial risks to the company)
 - ERM process did not address safety risks
- No internal reporting mechanisms that assured that safety concerns reached the Board or Audit Committee
- The Board passively received reports about the first crash from management and did not initiate action
- No minutes of special Board meetings where the crash was discussed

In Re Boeing Company Derivative Litigation (Del. Ch. Sept 7, 2021)

- December 2018 Board minutes document focus on restoring profitability
- February 25, 2019 minutes indicate that the Board “decided to delay any investigation until the conclusion of the [FAA] regulatory investigations or until such time as the Board determines that an internal investigation would be appropriate.”
- March 10, 2019 – second 737 MAX crashes in Ethiopia
- April 4, 2019 – Boeing Board initiates safety reporting to a new Board level “Airplane Committee”
- December 2019 – Compliance report includes new “safety” category for the first time

In Re Boeing Company Derivative Litigation (Del. Ch. Sept 7, 2021)

Plaintiff's have stated a prong 1 claim

- No Board committee with responsibility to monitor airplane safety
- Board did not monitor, discuss, or address safety on a regular basis
- No regular process or protocols requiring management to apprise the Board of airplane safety (instead, Board received ad hoc management reports, only favorable or strategic information)
- Management saw red, or at least yellow, flags, but that information never reached the Board

In Re Boeing Company Derivative Litigation (Del. Ch. Sept 7, 2021)

Plaintiff's have stated a prong 2 claim

- Board knew of 1st crash for a week before an “optional” meeting to discuss the crash
- Board was aware of reports that 737 MAX systems were at fault but did not question management
- Board formally resolved to “delay any [internal] investigation” until the FAA investigation was completed

In Re Boeing Company Derivative Litigation (Del. Ch. Sept 7, 2021)

Plaintiff's have stated a prong 2 claim

- Emails from Board members following the second crash show that the Board knew it was not meeting its oversight obligations
- “That the Board knowingly fell short is also evident in the Board’s public crowing about taking specific actions to monitor safety that it did not actually perform.”

Firemen's Retirement System of St. Louis v. Sorenson (Del. Ch. Oct 5, 2021)

- Allegation that Marriott BOD breached its fiduciary duty of loyalty by
 - Failing to conduct adequate due diligence of the Starwood systems pre-acquisition; and
 - (Post-acquisition) by continuing to operate Starwood's deficient systems, and by failing to timely disclose the breach
- No prong 1 claim: board was regularly appraised on cybersecurity risk, provided with annual reports on companies ERM assessment (incl cybersecurity), engaged outside consultants to evaluate and advise on cyber risk.
- No prong 2 claim: there were no red flags suggesting legal violations by the company – Marriott was victim of a criminal hacker. Marriott fail to meet any legal/regulatory obligations itself

In re McDonald's Corporation Stockholder Derivative Litigation (Del. Ch. January 25, 3034)

- Suit alleges that former EVP & Chief People Officer breached his fiduciary duty of loyalty by allowing a corporate culture to develop at McDonalds that condoned sexual harassment and misconduct.
- Court holds for the first time that the *Caremark* duty of oversight applies to officer just as it does to directors
 - Allegations of sexual misconduct may be a basis for a Caremark claim.



GUIDANCE: WHAT IS REQUIRED FOR BOARD TO BE EFFECTIVE IN COMPLIANCE PROGRAM OVERSIGHT?



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Federal Sentencing Guidelines

Board's leadership obligations:

- Be knowledgeable about the content and operation of the compliance and ethics program;
- Exercise reasonable oversight with respect to the implementation and effectiveness of the compliance & ethics program

Federal Sentencing Guidelines

KNOWLEDGEABLE ABOUT THE CONTENT AND OPERATION OF THE COMPLIANCE PROGRAM

“The knowledge about program features and operations that members of a governing authority should gain includes:

- practical management information about the major risks of unlawful conduct facing their organization;*
- the primary compliance program features aimed at counteracting those risks; and*
- the types of problems with compliance that the organization and other parties with similar operations have encountered in recent activities.”*

(Report of the Ad Hoc Advisory Group leading to the 2004 Sentencing Guidelines amendments, October 7, 2003)

Federal Sentencing Guidelines

EXERCISE REASONABLE OVERSIGHT

“The provisions of this proposal describing the oversight duties of governing authority members recognize that effective management requires that governing authorities be proactive in

- seeking information about compliance problems,*
- evaluating that information when received, and*
- monitoring the implementation and effectiveness of responses when compliance problems are detected.”*

(Report of the Ad Hoc Advisory Group leading to the 2004 Sentencing Guidelines amendments, October 7, 2003)

U.S. DHHS Office of the Inspector General

<https://oig.hhs.gov/compliance/compliance-guidance/compliance-resource-materials.asp>

- *Practical Guidance for Health Care Governing Boards on Compliance Oversight (April 20, 2015) (with AHIA, AHLA & HCCA)*
- *The Health Care Director's Compliance Duties: A Continued Focus of Attention and Enforcement (2010) (with AHLA)*
- *13 Additional Resources for Boards of Directors*

U.S. DHHS OIG CIA – Board Oversight Resolution

“The Board has made a reasonable inquiry into the operations of XYZ’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, XYZ has implemented an effective Compliance Program to meet Federal health care program requirements and the obligations of the CIA.”

STATE AG GUIDES FOR NON-PROFIT BOARDS

OH: *Guide for Charity Board Members*,
<https://www.ohioattorneygeneral.gov/GuideforCharityBoardMembers> .

WA State: *Charity & Non-Profit Board Services in Washington State, A Quick Guide*,
<https://www.sos.wa.gov/assets/charities/2015-quick-guide-for-board-service.pdf>

MA: *Guide for Members of Public Boards and Commissions*,
<https://www.mass.gov/files/documents/2017/12/12/OIG-Guide-for-Members-of-Public-Boards-and-Commissions-December-2017.pdf>

NV: *A Guide to Non-Profits*,
https://ag.nv.gov/uploadedFiles/agnv.gov/Content/How_Do_I/NDOJ_Guide_to_Non-Profits.pdf

OR: *A Guide to Non-Profit Board Service in Oregon*,
<https://www.doj.state.or.us/wp-content/uploads/2017/03/guide-nonprofit-board-service.pdf>

NH: *Guidebook for New Hampshire Charitable Organizations*, <https://www.doj.nh.gov/charitable-trusts/documents/guidebook-non-profit-organizations.pdf>

CA: *Attorney General's Guide for Charities (115 Pages!!)*,
https://www.oag.ca.gov/sites/all/files/agweb/pdfs/charities/publications/guide_for_charities.pdf

VT: *Understanding Your Responsibilities, Guidance for Board Members of Charitable Nonprofit Organizations in Vermont*,
<https://ago.vermont.gov/wp-content/uploads/2018/01/Charitable-Nonprofit-Board-Guidance.pdf>

IL: *Volunteer Board Members of Illinois Not-for-Profit Organizations*,
<https://illinoisattorneygeneral.gov/charities/volunteers.html>

TN: *What Every Board Member Should Know*,
<https://www.tn.gov/content/dam/tn/attorneygeneral/documents/nonprofits/nonprofitguidebook.pdf>



TEN ESSENTIAL STRATEGIES TO HELP YOUR BOARD SUCCEED



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Ten Strategies to Help Your Board Succeed

1. BE AWARE OF NEW DISCOVERY TACTICS AND WHAT THEY MEAN

“It is hard to overstate the importance of expanding the scope of section 220 to informal, electronic communications. Formal documents such as board minutes are usually drafted after the fact, by paper-trail-generating lawyers. Informal electronic communications in social media and emails are done in real time and usually less carefully edited.” (at pg. 21)

“Armed with this increasingly potent investigatory tool [DGCL §220], shareholders can now plead with particularity facts indicating that red flags were flown in the directors’ face, thereby surviving the once-insuperable Caremark pleading hurdle.” (at pg. 11).

A *New Caremark Era: Causes and Consequences*, Roy Shapira, Forthcoming, Wash. U. L. Rev.

Ten Strategies to Help Your Board Succeed

2. DEDICATE BOARD/COMMITTEE TIME TO COMPLIANCE PROGRAM OVERSIGHT.

Marchand

“Blue Bell had no board committee charged with monitoring food safety”

“Blue Bell’s full board did not have a process where a portion of the Board’s meetings each year . . . were specifically devoted to food safety compliance”

BOEING

The Boeing Board had no committee charged with direct responsibility to monitor airplane safety

Ten Strategies to Help Your Board Succeed

3. IMPLEMENT A PROCESS TO BRING SIGNIFICANT CONCERNS TO THE BOARD'S ATTENTION

Marchand

“Despite management’s knowledge of the growing problem, the complaint alleges that this information never made its way to the board, and the board continued to be uninformed about (and thus unaware of) the problem.”

“The Blue Bell Board did not have a protocol [or] any expectation that management would deliver key food safety compliance reports or summaries of these reports to the board on a consistent and mandatory basis.

“The complaint supports an inference that no system of board-level compliance monitoring and reporting existed at Blue Bell.”

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3. IMPLEMENT A PROCESS TO BRING SIGNIFICANT CONCERNS TO THE BOARD'S ATTENTION

Boeing

“Neither the Audit Committee, nor any other Board committee, reviewed whistleblower complaints related to product safety.”

“Boeing management knew that the 737 MAX had numerous safety defects, but did not report those facts to the Board.”

Ten Strategies to Help Your Board Succeed

4. ASSURE THAT BOARD MINUTES REFLECT COMPLIANCE-RELATED DISCUSSIONS AND ACTION TAKEN

Marchand

“Minutes from the board’s . . . meetings are bereft of . . . any board level discussion regarding food safety.”

Boeing

“This was the first time the Board convened after the crash. There are no minutes.”

Ten Strategies to Help Your Board Succeed

4. ASSURE THAT BOARD MINUTES REFLECT COMPLIANCE-RELATED DISCUSSIONS AND ACTION TAKEN

Amerisource

“Plaintiff is entitled to the inference that the Board never discussed the subpoena due to its absence from the Board’s minutes.”

“I find that the absence of any discussion of the subpoena by the Board is sufficient to make reasonable the inference . . . even after receiving the subpoena the Board did nothing to correct the underlying mission critical compliance shortcomings . . .”

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5. WHEN ACTION IS REQUIRED, THE BOARD MUST TAKE ACTION!

In Re: Clovis Oncology, Inc.

Board received repeated indications that Clovis is not following FDA protocols in measuring cancer trial drugs efficacy and is publicly reporting misleading information in support of capital drives/stock sales.

“Notwithstanding this revelation, the Board did nothing.”

“With hands to their ears to muffle the alarms . . . [Board Members] signed Clovis’ 2014 Annual Report.”

“The prospectus for the [stock] offering [that contained misleading information about the drug’s efficacy] was signed by the entire Board.”

. . . plaintiffs “have well-pled that the Board consciously ignored red flags that revealed a mission critical failure to comply with . . . FDA regulations . . . [and] that this failure of oversight caused monetary and reputational harm to the Company . . .”

Ten Strategies to Help Your Board Succeed

6. THE BOARD SHOULD USE AND RELY ON EXPERTS

In re Caremark

“On February 8, 1993, the Ethics Committee of Caremark's Board received and reviewed an outside auditor's report . . . which concluded that there were no material weaknesses in Caremark's control structure.”

Stone v. Ritter

“The [external firm's] Report reflects that the directors not only discharged their oversight responsibility to establish an information and reporting system, but also proved that the system was designed to permit the directors to periodically monitor AmSouth's compliance with . . . regulations.”

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7. THE BOARD MUST ASSURE THAT EXPERTS RECOMMENDATIONS ARE ADDRESSED

Amerisource

“... in 2010 [expert] was brought in to conduct a compliance and regulatory review in response to [qui tam] allegations. But... the Audit Committee never followed up to determine if [experts] recommendations were implemented, and no policies or procedures were created or changed as a result of the review.”

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8. BOARD MUST ASSURE THAT THE COMPLIANCE OFFICER HAS APPROPRIATE ACCESS TO THE BOARD OF DIRECTORS

DOJ Compliance Guidance

“Prosecutors should address . . . whether those responsible for compliance have . . . Sufficient autonomy from management, such as direct access to the board of directors or the board’s audit committee.”

“[Has] the board of directors. . . held executive or private sessions with the compliance and control functions?”

U.S. Department of Justice, Criminal Division, Evaluation of Corporate Compliance Programs (Updated June 2020)

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9. BOARD MEMBERS SHOULD CONFIRM THAT THE COMPLIANCE PROGRAM AND PROCESSES ARE WORKING EFFECTIVELY

“The Board has made a reasonable inquiry into the operations of XYZ’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, XYZ has implemented an effective Compliance Program to meet Federal health care program requirements and the obligations of the CIA.”

How?

- Ask questions
- Test the processes
- Consider periodic assessment by external expert

Ten Strategies to Help Your Board Succeed

10. INCLUDE A COMPLIANCE EXPERT ON THE BOARD OR BOARD OVERSIGHT COMMITTEE

DOJ Compliance Guidance

“What compliance expertise has been available on the board of directors?”

OIG Board Guidance

“The presence of a professional with health care compliance expertise on the Board sends a strong message about the organization’s commitment to compliance, provides a valuable resource to other Board members, and helps the Board better fulfill its oversight obligations.”

Practical Guidance for Health Care Governing Boards on Compliance Oversight, (April 20, 2015), US DHHS OIG, AHIA, AHLA, HCCA

QUESTIONS?

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