I’m on a Board. What are my Legal and Ethical Responsibilities?

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Agenda

Part I: Board Responsibilities
Part II: Sarbanes – Oxley
Part III: Antitrust
Part IV: Compliance
Part V: Q&A
Part I: Board Responsibilities

Board Responsibilities

- Duty of Care
- Duty of Loyalty
- Duty of Obedience
Director and Officer ("D&O") Insurance should be provided to protect board members and officers.

Duty of Care

The Board Must:

• Act in good faith.
• Exercise the level of care an ordinarily prudent person would exercise under similar circumstances.
• Act in manner that directors believe to be in the best interests of the corporation.
Board Responsibilities Under Duty of Care

The Board is responsible for:

- Decision making for the corporation; and
- Oversight functions.

Decision Making

The board must act in good faith as would an ordinarily prudent person in like circumstances for the best interests of the corporation.
Good Faith

Good faith means that the action or transaction does not give anyone a financial benefit and there is no intent on the part of the board member to take advantage of the corporation. Honesty in the director’s actions to the director’s duties and obligations.

Ordinarily Prudent Person

This is usually referred to as a person who possesses and shows informed judgment and common sense. This does not require any special skills.
Like Circumstances

This is a test where the courts would consider the actions of the director based on the individual and specific circumstances at issue. Including: the size of the organization, complexity, its mission, the availability of information to the Board when the decision is made, the urgency of the situation and the risks and benefits to the corporation.

Best Interests of the Corporation

This relates to the duty of loyalty, and the director must be disinterested as it relates to the matter being dealt with. It is a subjective belief that the action is in the best interests of the corporation.
Oversight

The oversight functions include oversight of the day-to-day operations.

Reasonable Inquiry

There is a duty to make a reasonable inquiry as to matters being decided by the board. A board member must pay particular attention when there are indications that a matter or situation is suspicious or unusual, for example, if there are indications of fraud or financial improprieties.
Reasonable Inquiry (cont'd)

The duty to make a reasonable inquiry does not require the directors to be detectives and seek out corporate problems unless there is some indication that there is a problem. The board can rely on experts, advisors, officers, employees and other third parties to provide the information necessary for the board to make a reasonable inquiry, unless there are circumstances indicating that the board should not be relying on those individuals. The board must have oversight of these individuals.

Reasonable Inquiry (cont'd)

Boards can also delegate some duties to board committees, but the board must be careful to evaluate the capabilities of the committee members and must monitor the actions of the committees.
Reasonable Inquiry (cont'd)

The board also has supreme authority over officers, including the officer appointments, duties, removal and compensation.

Reasonable Inquiry (cont'd)

In the for-profit world, there is a concept called the business judgment rule. This is where the courts would not find a director liable if the director was a disinterested party, reasonably informed and believed that the action was in the best interests of the corporation. The applicability of the business judgment rule to non-profit corporations varies in each state.
Actions by the Board to Insure Compliance with Duty of Care

1. Establish a corporate compliance program
   • Make sure there is a program/plan in place; and
   • Make sure that the program/plan works to assure the board will have information necessary in a timely manner to enable it to comply with the law

Actions by the Board to Insure Compliance with Duty of Care (cont’d)

There will not be an automatic assumption of director or board liability just because one employee or officer does not comply with the compliance plan, or if there is an issue that arises despite the presence and implementation of a compliance plan.
Actions by the Board to Insure Compliance with Duty of Care (cont’d)

2. Board members should read the materials prepared for the meeting, including minutes of prior meetings, financial statements and employee reports. Make changes or corrections if necessary.

3. Attend Board meetings, actively participate and vote in the Board meetings.

4. Participate in committee meetings.
Actions by the Board to Insure Compliance with Duty of Care (cont’d)

5. Participate in discussions regarding risk assessment, strategic planning for the corporation’s future, finances (current, and projected).

Actions by the Board to Insure Compliance with Duty of Care (cont’d)

6. Appointment and review of key personnel running the day-to-day operations, including the CEO and CFO.
Examples of Duty of Care Cases

*McCall v. Scott (2001):* Sixth Circuit determined that a health care company board’s inactions when there was evidence of systematic fraud presented a substantial likelihood of director liability for intentional or reckless breach of the duty of care. The case was remanded for further proceedings on the issue.

*Lampe v. Lampe (2011):* Third Circuit held that a director breached his duty of care by failing to retain counsel for the company and defend against a lawsuit that was initiated by the director. The lawsuit had resulted in a default judgment against the company.

Duty of Loyalty

Board members must act in good faith and with loyalty to the organization. The purpose is to further the organization’s goal and mission.
Duty of Loyalty (cont’d)

Directors must be disinterested with their loyalty to the organization to further the organization’s goal and mission – not self interested. The two usual culprits that will be problematic are conflicts of interest and loans by the corporation to a board member. In many states, there are limits or prohibitions on loans the corporation may make to the board members.

Duty of Loyalty – Conflicts of Interest

Conflicts of Interest. This is when a director uses his or her position on the board or knowledge from service on the board for financial gain for his or herself and/or family. The director can have a direct or indirect interest (conflict).
Duty of Loyalty – Direct Conflict

**Direct Conflict.** Examples of direct conflict include: The director performs professional services for the corporation such as: banker, attorney, real estate agent, investment counselor, etc.

Duty of Loyalty – Indirect Conflict

**Indirect Conflict.** An example of an indirect conflict is a board member whose spouse runs a catering company. The organization is having a gala fundraiser and the board member suggests using his/her spouse to cater the event. The board votes to use the spouse for the catering without obtaining any other bids.
Duty of Loyalty – Conflicts of Interest

The best way to avoid any problems with potential or actual conflicts of interest is to have a conflicts of interest policy.

Duty of Loyalty – Loans

States vary regarding whether loans are permitted.

Under Sarbanes-Oxley (applicable to publicly traded corporations), virtually all loans and advances to officers and directors are now banned.
**Duty of Loyalty – Conflicts of Interest**

1. Must have a Conflict of Interest Policy
2. Conflicted board members should not be permitted to vote on the matter; should recuse himself/herself from discussions.
3. Interested board members should not be present for any discussion involving the conflicted matter, otherwise honest discussion will be inhibited.
4. Vote must be made by a majority of disinterested directors (interested directors can be counted for the quorum).
5. Applies to board members, immediate family and any company the board member or family is affiliated with.
6. The IRS also has provisions governing “self dealing” for directors of private foundations.

**Conflicts of Interest**

- Policies
- Review
- Resolution
Conflicts of Interest Policies

1. Who will the policy cover? At a minimum should cover all of the board members, paid and volunteer.

2. Who is responsible for dealing with actual or potential conflicts? i.e. corporate compliance officer, general counsel, outside counsel.

3. What is covered by policy? At a minimum the policy must cover financial dealings with board members.

4. How will policy be enforced?

5. Insuring that all board members are familiar with policy.

6. Regular review of the policy.

7. Questionnaires – for potential or actual conflicts.

Conflicts of Interest Policies

These questionnaires should be completed on an annual basis.

If there is a conflict, the transaction is considered voidable, that is, the transaction can be undone. The courts will look at the transaction to determine whether the majority of disinterested board exercised duty of care and normal business judgment and whether the transaction is beneficial to the company.

Board minutes should reflect process of dealing with potential conflicts of interest.
Confidentiality

All information that a director obtains that is non-public, should be kept confidential, including any information disclosed as it relates to a conflict of interest policy.

Duty of Obedience

Board members must be faithful to the purposes and goals of the organization. The board members must follow the purpose for which the entity was created – purpose can be found in:

- Certificate of Incorporation and any amendments
- By-Laws
- Mission documents, such as proposals or public solicitations

The board is obligated to insure that the corporation adheres to all appropriate laws – regulatory, tax, employment, civil rights, etc.
Part II:
Sarbanes - Oxley

Sarbanes – Oxley (“SOX”)

Enacted in 2002 in response to scandals at large companies Enron, Arthur Anderson, Worldcom, Tyco and Adelphia.

Applies to publicly traded corporations and includes reporting requirements, restrictions and standards relating to money management, deceptive marketing and advertising, tax issues, executive pay and retirement pay, vacation and sick leave, business expense reimbursement, loans, whistleblower provisions and document retention provisions.
SOX – Application to All Companies

- Whistleblower Criminal Provisions

- Document Destruction Criminal Provisions aka Document Retention

1. §1107 provides for protection of whistleblowers. It is a criminal offense for a corporation to punish an employee who reports truthful potential violations of federal law to law enforcement officials.

2. §§ 802(a) and 1102 contain the document destruction criminal provisions which provide for criminal penalties for any person who either alters, destroys or conceals, or attempts to alter, destroy or conceal any document, record or object with the intent to impair its integrity or available for use in an official proceeding, or in any other way to obstruct, influence or impede an official proceeding.
SOX – Corporate Governance Reforms

- Audit Committees
- Auditor Provisions
- Certification of Financial Statements
- Executive and Director Compensation, Loans and Expense Reimbursement

SOX - Corporate Governance Reforms (cont’d)

While these are not mandatory, many boards have chosen to follow these SOX provisions that are mandatory for publicly traded companies. Depending on size or the corporation and of course funding. Many of the requirements also include reporting to the SEC which, of course, would not be applicable. However, if the corporation chooses to implement any or all of these provisions, the actions should be documented and reports should be provided to, and carefully studied by, the board.
SOX - Corporate Governance Reforms (cont’d)

1. Audit Committees. The board should appoint an independent audit committee that oversees the outside auditors. Independent means that the committee member can only accept fees from the company for serving on the board and on the audit committee. There must be at least one financial expert on the audit committee. The company’s CEO, CFO and other fiscal officers should attend the committee meetings, but they should not be members of the board.

SOX - Corporate Governance Reforms (cont’d)

2. Auditor Provisions. Prohibits the auditor from providing non-auditing services at the same time it is conducting an audit. The audit committee has to approve all audit and non-audit services that would be permissible: Lead audit partner, audit firm and lead review partner should be changed every 5 years, and the auditor cannot provide auditing services if the CEO, CFO, chief accounting officer or controller of the corporation was employed by the auditing company and participated in any way in the audit of the company within the year preceding the audit.
SOX Corporate Governance Reforms (cont’d)

3. Certification of Financial Statements. CEO and CFO must certify that they have reviewed the reports, that based on their knowledge, there is no misstatement or omission of a material fact, and that the statements are not misleading, and that the financial statements and the information contained in the report fairly represent, in all material aspects, the financial condition and results of operations of the company.

SOX Corporate Governance Reforms (cont’d)

4. Executive and Director Compensation and Loan and Expense Reimbursement. Review of the propriety of the compensation (salary and bonuses) of executives and directors, loans to directors and executive officers by the corporation are prohibited, and there must be a review of the reimbursement for expenses. There is an exception for companies that regularly provide consumer credit services to the public so long as the loans are offered on the same terms as to the public.
SOX

Mandatory provisions applicable to all companies - whistleblower and document retention

Optional – auditor provisions, certifications of financial statements, loans, executive compensation and reimbursement

Part III:
Antitrust
Antitrust

The antitrust laws prohibit collaborations or agreements that restrain competition. Arrangements that violate antitrust laws are those that:

- Raise prices or fees above the competitive level, or
- Lower the quantity or quality of goods or services below the competitive level.

Antitrust (cont’d)

There are restraints that automatically violate the antitrust laws (per se violations); and other actions that may be a violation depending on their net impact on competition (rule of reason violations).
Antitrust (cont’d)

Per se violations include:

• Agreements among competitors to set prices or fees;
• Agreements not to deal with certain entities in the marketplace;
• Agreements to divide or allocate territory or markets; and
• Requirements imposed by a dominant provider of a good or service conditioning the purchase of that good or service (the “tying” product) on the purchase of a separate product or service (the “tied” product).

Antitrust (cont’d)

Avoid agreements or collaborations to:

• Fix commercial prices or professional fees;
• Restrict non-deceptive advertising;
• Refuse to deal;
• Divide or allocate products or markets;
• Tie the purchase of goods or services;
• Reduce quality or quantity of goods or services.
Antitrust (cont’d)

Be very careful about sharing information relating to prices or output, or information that could lead indirectly to higher prices.

If a question arises where the board has a concern about a possible antitrust violation legal counsel should be consulted.

Part IV:
Compliance
Compliance

- Cases
- Policies
- Sarbanes - Oxley

Caremark – This is a 1996 case that is important for the concept of the expansion of personal liability for a board of directors that fails to implement and carry out a corporate compliance program. The case involved a government investigation, plea agreement, civil and criminal fines and reimbursement of almost $250 million by Caremark International, Inc. While the Board in this case was not found personally liable, the Delaware court found that “it is important that the board exercise a good faith judgment that the corporation’s information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility”.

Compliance
Compliance (cont’d)

**Memphis Health Center, Inc. v. Gran et al.** Filed July 28, 2006 from the Court of Appeals of Tennessee. This case was a derivative action (which is an action brought by one or more members, directors or shareholders of a corporation to redress an injury sustained by, or to enforce a duty owed to, a corporation). In this case, a former board member who had been ousted brought a claim against the Board for a violation of their fiduciary duties by violating the bylaws of the corporation and violating federal law. The trial court found that the Board had violated an injunctive order to act in accordance with the health center’s bylaws and in the best interests of the corporation and then ordered all the defendant board members to be removed from the board.

Compliance (cont’d)

The Court of Appeals affirmed the lower court’s finding that the members of the board of Memphis Health Center Inc. had violated their fiduciary duties to the hospital by failing to investigate or take action against a board member that had been found guilty of 3,306 violations of the Federal False Claims Act, and the trial court’s order to remove the board was warranted.
Policies

- Compliance
- Conflicts of Interest
- Confidentiality

Policies (cont’d)

The IRS has prepared a “Governance and Related Topics – 501(c)(3) Organizations” document, available at:

Policies (Cont’d)

The IRS document focuses on 6 categories of governance:

1. Mission – The mission explains the purpose of the charity and addresses why it exists, guides the work of the charity, the goals the charity hopes to accomplish, and what activities will be undertaken.

2. Organizational Documents

3. Governing Body – “Governing boards should be composed of persons who are informed and active in overseeing a charity’s operations and finances.”

Policies (cont’d)

4. Governance and Management Policies
   1. Executive Compensation
   2. Conflicts of Interest
   3. Investments
   4. Fundraising
   5. Governing body minutes and records
   6. Document retention and destruction
   7. Ethics and Whistleblower policy

5. Financial Statements and Form 990 Reporting

6. Transparency and Accountability
Policies (cont’d)

OIG Guidance for Health Care Boards

- **Available at:**

- The board should be involved in oversight activities and integrating compliance throughout the organization

- **Key roles of the board:**
  - Compliance oversight
  - Structuring the compliance program
  - Evaluating the effectiveness of standards and procedures

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Policies (cont’d)

- **The OIG recommends that boards:**
  - Engage in oversight responsibilities
  - Diversify areas of expertise (a board should have appropriate experience)
  - Stay informed on risk areas and compliance issues
  - Attend compliance training and speak to the organization’s staff about compliance issues
  - Adapt to changing health care delivery and reimbursement risks
Policies (cont’d)

- The OIG recommends that a board should ask the following questions about the organization’s compliance program structure:
  - Does your compliance officer have sufficient influence?
  - How does your organization encourage communication?
  - Are compliance goals periodically adjusted?
  - How does the board encourage compliance in daily decision-making?
  - Does the board hold key employees accountable?

Policies (cont’d)

- The OIG recommends that a board ask the following questions to determine the effectiveness of a compliance program:
  - What metrics are used to evaluate compliance?
  - How does the organization identify gaps in quality?
  - Is the organization conducting internal audits?
  - Is the organization’s response to problems sufficient (e.g., tracking corrective action plans)?
  - Has the compliance officer identified hurdles to promoting compliance?
OIG Resources

OIG https://oig.hhs.gov/compliance/compliance-guidance/compliance-resource-material.asp

Part V:
Questions  ??????????