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Supporting the Health Care Board's Expanded Oversight Responsibilities: A Challenge for the General Counsel

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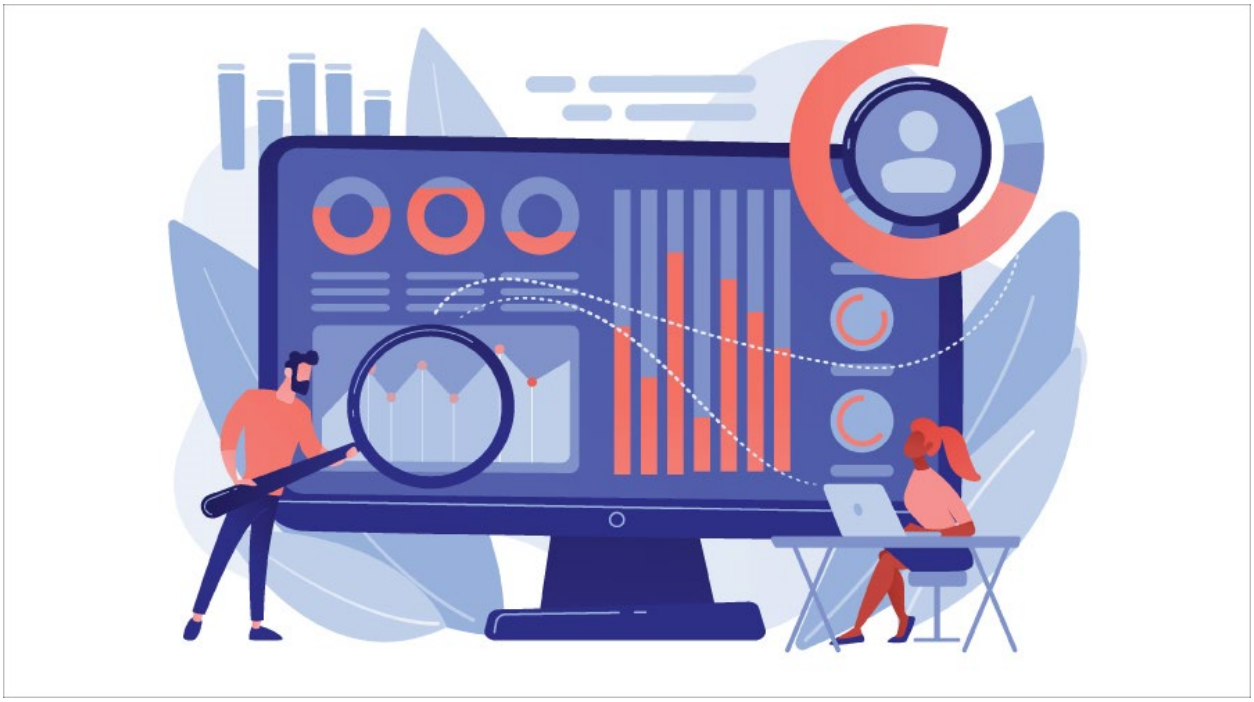

One of the most significant, yet discreet, governance developments of the pandemic era has been the expansion of corporate directors' oversight obligations. While fundamentally grounded in the events of the COVID-19 crisis, this expansion is ultimately more the byproduct of evolving third-party expectations that directors be attentive to a larger universe of issues than before. And it's a notable shift, that will significantly impact on how directors perform their duty of care in the future.

The shift will be felt especially in industries such as health care, that are impacted by forces such as pandemic-driven product/service diversification, heavy regulation, large and diverse workforces, broad investment portfolios, and increasing dependence on technology.

This may come as a surprise to many boards. It's not as if this oversight duty expansion arose "with the sound of trumpets." Rather, it has seeped out through a combination of recent judicial decisions, release of governance principles, and policy developments. It will require material adjustment to some board practices. And it will fall to the general counsel, as the board's primary legal and governance advisor, to share the message with the full leadership team.

Basic Principles of Oversight

It is a basic corporate governance principle that directors serve as diligent monitors, but not managers, of business operations. In this role they exercise robust, diligent oversight of corporate affairs—but are not expected to interfere with management's conduct of day-to-day operations.[1] This monitoring, or oversight, role is incorporated in many state corporation statutes[2] and is a foundational element of the fiduciary duty of care.[3]

That key duty generally refers to the exercise of proper care in conducting director responsibilities relating to both decision making, and to oversight. As to the latter, it calls on directors to exercise reasonable care in monitoring the day-to-day business operations of the corporation, and to assure that corporate executives carry out their management responsibilities and comply with the law.[4]

Impact of Recent *Caremark* Decisions

The recent focus on expanded oversight obligations is primarily, but not solely, the result of a series of Delaware decisions since July 2019 that have been interpreted as weakening director liability protections provided under the so-called *Caremark* principle.[5] As most chief legal and compliance officers know, *Caremark* provides that a director has a duty to attempt in good faith to assure that (1) a corporate information and reporting system exists (Prong One), and that (2) this reporting system is adequate to assure the board that appropriate information as to compliance with applicable laws will come to its attention in a timely manner as a matter of ordinary operations (Prong Two).

Establishing director liability for breach of the *Caremark* obligation has traditionally been viewed as one of the most difficult theories in corporate law to prove.[6] However, the post-July 2019 decisions demonstrate that courts will give strong consideration to well-pled arguments indicating that a board's information and reporting system was so deficient as essentially to constitute no system at all. These decisions reflect a particular focus on the company's "mission critical" risks and offer the perspective that governance oversight of such risk is to be "rigorously exercised."[7]

A September 7, 2021 Delaware Chancery further demonstrated this trend by applying the "mission critical" oversight expectations to matters of product safety.[8] It is a decision that

has attracted attention in corporate governance dialogue (particularly as to health care and life sciences boards, given the nexus between product safety and patient quality of care and safety).

Relying in large part on the interpretation of *Caremark* set forth in the Delaware Supreme Court's 2019 decision of *Marchand v. Barnhill*,[9] the Chancery Court concluded that the plaintiffs sufficiently pled particularized facts supporting a conclusion that neither "Prongs" of the *Caremark* standard were satisfied by the board's level of oversight.

The Prong One deficiencies arose from allegations that the board: (1) had no committee charged with direct responsibility to monitor product safety; (2) did not monitor, discuss, or address product safety on a regular basis; (3) had no regular process or protocols requiring management to apprise the board of product safety, but rather only received ad hoc management reports that in this circumstance conveyed only favorable or strategic information; (4) was not informed that management saw red, or at least yellow, flags of safety concern; and (5) knew that it should have had structures in place to receive and consider safety information.

The Prong Two deficiencies overlapped with those arising under Prong One; i.e., that the board was aware of lethal product failure—the proverbial red flag—yet acted in bad faith by consciously disregarding its duty to address that product failure.

Other Contributing Factors

But this expanded oversight focus also arises from more subtle concerns that the increasingly complex and diversified operations of many business organizations have outgrown traditional expectations of board oversight, and that more fulsome efforts—short of direct involvement in management—are required to protect constituent interests.

These concerns arise beyond the traditional areas of board oversight (e.g., strategic planning, compliance, executive compensation, financial reporting) and the familiar areas of government regulation, to challenges associated with business disruption, expanded perspectives on corporate purpose, the evolution to a digital economy, and transformational legislation.

From a health care company or provider system perspective, the board can now logically be expected to exercise material oversight over management's approach to the following complex operational tasks (among others):

- The preparation and implementation of *"business resiliency"* plans in the event of major crises (e.g., COVID-19), including efforts to evaluate and implement as necessary the innovations born of necessity during the crisis period.

- The nature of *Artificial Intelligence (AI) technology,* together with the pace and proliferation of AI discovery, investment, and deployment in health care (particularly in clinical care).
- Addressing a wide range of *workforce culture* considerations, including but not limited to "return to work" policies and employee and workplace safety measures.
- Burgeoning *human capita*l challenges associated with employees who are choosing not to return to work; the narrowing pool of qualified job candidates and the particular health care challenges of fatigue and dissatisfaction of nurses, physicians, and other clinicians and employees.
- The supervision of complex *diversified, non-provider corporate affiliates* operating within the health system, with decidedly for-profit orientation and subject to different management styles and strategies, as well as compensation and benefits.
- The *unique economic challenges* associated with the vacillations in the unemployment rate; the vexing issue of labor supply and the continued low job participation levels; unpredictable consumer confidence index results and stubbornly rising inflation rates.
- *Barriers to strategic developmen*t and non-organic growth raised by the Biden administration's aggressive new policies on competition and antitrust enforcement.
- Operational challenges created by the continued *global supply chain disruption*—with its particular impact on health care access to protective gear, medicines, supplies, and patient care technology.
- External and internal (constituencies in workforce) pressures on the organization and its executive leadership to address "hot button" issues of *social justice* and the risks associated with corporate and executive responses to these pressures.
- Expectations with respect to the implementation of measures intended to address identified *environmental, social, and governance challenges*, particularly those with a direct relationship to health care (e.g., racial disparities in care delivery).
- Renewed obligations to assure a *culture of compliance* with law given the new Department of Justice corporate fraud enforcement policy.[10]

These are but a few examples; with some level of thought more can be identified.

Why We Care

There are two principal governance related concerns with increased expectations of director oversight, with which many sophisticated chief legal and compliance officers are readily aware.

First is that interest in the board's implementation of expanded oversight responsibilities is broad based.

At one level are the state and federal governmental agencies that monitor performance of health care corporate governance, including but not limited to the Department of Justice,

the Federal Trade Commission, and the Department of Health and Human Services/Office of Inspector General; for publicly traded health care companies, the Securities and Exchange Commission; ratings agencies; and for nonprofit, tax-exempt health care companies, the state attorney general, the state secretary of state, and the Internal Revenue Service.

At a second level are a combination of disparate parties: shareholders (for for-profit health care companies); activist investors, public pension funds; proxy advisories and asset management firms (for publicly held health care companies); and the broader set of corporate constituents recognized by corporate social responsibility principles, e.g., health care consumers, communities served by the enterprise, employees/the organized workforce, and vendors and suppliers. And there is always the voracious diligence of unsecured creditors. There is also the increasingly powerful voice and influence of "the new media"; i.e., ProPublica, STAT, Politico, and the few remaining investigative units of national newspapers (e.g., the Boston Globe's "Spotlight") that have demonstrated unusual tenacity on corporate governance matters.

And, of course—without being alarmist—there is also the interest of the plaintiff's bar in the pursuit of derivative actions against boards for alleged failure to maintain *Caremark* standards. (The same motivation might apply to state charity officials with respect to boards of nonprofit systems.) Note in this regard the recent record-setting $237.8 million settlement of a *Caremark*/breach of duty of oversight case involving allegations of significant board oversight failings. These types of large settlements (which are typically funded by D&O policies) may have a two-fold impact: first, possibly emboldening plaintiffs lawyers and regulators to pursue future *Caremark* challenges; and second, possibly increasing the cost and accessibility of D&O coverage.

Second is that many existing governing board structures are not well situated to respond to these increased expectations. Most are small by design; e.g., 12-15 in many circumstances—a size that has been sufficient to provide oversight of the traditional risk factors but that may challenge the ability of directors to be attentive to a much broader list of concerns. In addition, many boards and their key committees are meeting less frequently, in deference to the personal time demands of individual directors. Furthermore, many boards are navigating their return to traditional levels of engagement following a COVID-19 period in which an extraordinary level of deference was given to executive management.

All of which is to suggest that there is a broad universe of third parties that, for financial, contractual, social, governmental, and other reasons actually care quite deeply about the effectiveness of corporate governance in general and the oversight obligations in particular—and they are often more than willing to use their platform to participate in governance discourse. And there is also reason to wonder whether the existing governance

structures of some organizations have the capacity to accept increased oversight responsibilities.

Special Board/Management Dynamics

The Chief Legal Officer, as the board's primary executive level governance advisor, is the logical corporate executive to advise the board with respect to the perceived expansion of its oversight—with the approval and support of the chief executive officer, of course. But obtaining that approval may prove more challenging than expected. Some CEOs are, perhaps understandably, reluctant to upset a management/board governance dynamic that provides substantial leadership deference to the senior executive team. They are also sensitive to the time commitments of their directors and to the risk of asking for a greater level of engagement. Indeed, many directors continue to serve on multiple outside boards and may also be fully occupied in the executive leadership of their own companies. As a result, they may lack the capacity to engage more fully in board oversight activities, whether it be through the consumption of more information, participation in additional committees, and/or attendance at additional meetings—whether in person or virtual. They have their limits of available commitment, and the CEO may be reluctant to authorize a message that such commitment must be expanded. Fortunately, the combination of the recent Delaware decisions, the increasing diligence of the "new media," the aggressive third parties, and the ultimate risk to the organization and its governance mechanism, should provide a strong basis for sharing the message with the board. No management team would consciously wish to expose its directors to the risk of oversight liability for insufficient monitoring of "mission critical" and similar material operating risks.

Recommended Action Measures

The *Caremark* and related cases, new governance principles, and comments from leading governance authorities offer the Chief Legal Officer a wide range of possible measures to recommend to the CEO and the health care board on how best to address the advent of increased oversight obligations. These include, but are not limited to:

1. Make an informed interpretation of the organization's mission critical risks to which the board must be particularly attentive.
2. Give particular consideration to the adequacy of parent board oversight of non-provider subsidiaries and other diversified investments.
3. Revisit existing management-to-board reporting expectations generally for clarity and materiality.
4. Enhance the current vertical management-to-board reporting system on those mission critical risks, with special focus on patient quality and safety matters.
5. Re-evaluate the parent-level board committee structure to determine the extent to which it adequately covers the range of identifiable oversight areas.

6. Provide education to the board on how it may enhance its ability to identify "yellow" and "red" flags of potential risk.
7. Confirm that the board does not "over delegate" to the audit committee or otherwise allow it to act, without justification, as the board's "kitchen junk drawer" of fiduciary responsibilities.
8. Assure that internal risk reporting systems extend to the highest level of corporate governance authority, not just to that of operational subsidiaries.
9. Discourage, if not eliminate, circumstances in which the board is solely dependent upon management, or ad hoc procedures, for providing updates on mission-critical operational risks.
10. Revisit the existing minute-taking and record retention processes to confirm that they regularly capture the board's active engagement in oversight of mission critical operations.
11. Confirm a shared perspective between the board and senior management on the board's ultimate responsibility to engage fully with management when mission-critical crises arise.
12. Reconsider the most effective size of the board and evaluate the ability to use non-directors as members of board.
13. Adopt specific policies that limit the number of other board seats that members of the board of directors may hold.
14. Re-evaluate the frequency and forum (e.g., virtual) of board and committee meetings.
15. Confirm that the Chief Legal Officer is an invited participant to all board meetings, serves as the board's primary legal advisor, and that members of the Department of Legal Affairs serve as staff to all board committees.

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1 The Business Roundtable, Principles of Corporate Governance 2016 (p. 3, 5), https://www.businessroundtable.org/policy-perspectives/corporate-governance/principles-of-corporate-governance.
2 *See, e.g.,* Del. Gen. Corp. Law, Chapter I, Subchapter IV Section 141(a).
3 Roundtable, *supra* note 1, at p. 5
4 Dep't of Health and Human Servs. Office of Inspector Gen. and Am. Health Law Ass'n, *Corporate Responsibility and Corporate Compliance, A Resource for Health Care Boards of Directors*, https://oig.hhs.gov/documents/compliance-guidance/816/040203CorpRespRsceGuide.pdf; Del. Gen. Corp. Law, Chapter I, Subchapter IV, Section 141(a)
5 *In re Caremark International Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

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6 *Stone v. Ritter*, 911 A.2d 362, 372 (Del. 2006) (quoting *Caremark*, 698 A.2d at 967).
7 *Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019).
8 *In re Boeing Co. Derivative Litg.*, No. 2019-0907-MTZ, 2021 WL 4059934 (Del. Ch. Sept. 7, 2021)
9 *Marchand,* 212 A.3d 805.
10 Michael Peregrine, *DOJ's New Focus on Corporate Crime and the Implications for the Governing Board,* Health Law Weekly (Nov. 5, 2021), https://www.americanhealthlaw.org/content-library/health-law-weekly/article/c4220cb7-7390-4ef3-b1e4-45f5d3adb3d0/DOJ-s-New-Focus-on-Corporate-Crime-and-the-Implica.