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Focus Renewed on **Risk Management**

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EVERY WELL PUBLICIZED financial scandal and crisis brings with it a new focus, applied with the benefit of hindsight. The steep losses of shareholder value and, indeed, the failure of major corporations that have been hallmarks of the recent financial crisis have caused renewed focus on risk management, and the role of boards and key committees overseeing the risks that their businesses take.

Board responsibility for the risks assumed by business is not a new concept. Balancing risk and reward has always been the fundamental dynamic of making business decisions.

State law provides substantial protection to directors against liability for losses that result from reasonable risks assumed. The prudent man rule, the time honored standard for judging the fiduciary behavior, permits risks to be taken, but requires that those risks be reasonable ones that fiduciaries would reasonably take in the management of their own affairs. The business judgment rule limits judicial review and the imposition of liability for losses resulting from reasonable assumption of risk.

A recent and relevant example of such state law protection is in *In Re Citigroup Inc. Shareholder Derivative Litigation*, which addressed the potential liability of directors under Delaware law. In that case, the Delaware Chancery Court rejected the theory that directors could be held liable for the substantial losses incurred by Citigroup as a result of the collapse of the subprime credit market, despite the alleged red flags that this market was on the verge of collapse.[1]

In most cases, assuming risk is an **inherent** element of business decisions and **falls squarely** within the protection of the **business judgment** rule. However, state law protection may **not** be **absolute**.

Under the business judgment rule a court will not re-examine or second guess a business judgment made in good faith, on an informed basis and where no self-dealing is involved.[2] The Delaware Chancery Court held that the business judgment rule would be eviscerated by subjecting business decisions to judicial review because risk has been assumed in the face of alleged red flags.[3]

The court recognized that in most instances, assuming risk is an inherent element of virtually all business decisions and falls squarely within the protection of the business judgment rule.[4]

However, the protection afforded by state law may not be absolute and there is the possibility that boards could face liability if proper risk monitoring procedures are not in place and/or followed (as opposed to being at risk for decisions regarding risk assumption).

The *In re Caremark Int'l Inc. Derivative Litigation* court focused on the process of decision making rather than on the decisions, themselves.[5] Directors may be found to have breached their duty when they have failed to institute or follow procedures that will enable them to monitor activities that result in corporate liability.[6]

To establish that a board failed to discharge its duty of oversight, a plaintiff has the heavy burden to show that a board either "(a) … utterly failed to implement any reporting or information system or (b) having instituted such a system consciously fails to monitor or oversee its operation, thus disabling themselves from being informed of risks requiring their attention."[7]

While, strictly speaking, the standards articulated in *Stone* and *Caremark* were applied to board supervision of corporate compliance issues (e.g., illegal conduct of employees) rather than board supervision of risk management, courts may apply those standards with respect to risk oversight as well.

The SEC's Proposal

In July 2009, the Securities and Exchange Committee issued a release proposing to require public company boards and board committees to articulate their oversight of risk and their consideration of the relationship of risk and compensation to shareholders and to the investment community.[8]

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The proposed disclosure rules will have a number of immediate effects. Boards will want to institute practices that will reflect positively on them when disclosure is actually required. At the same time, as described later in this article, increased involvement in risk management at the board level may further blur the line between oversight and management.

The enhanced disclosure of board oversight of risk also raises the danger, disclaimed by the SEC,[9] that the increased focus on risk at the board level, in effect mandated by the proposed new disclosures, will result in boards taking actions to eliminate risk that may be counterproductive to a robust economic recovery.

The SEC's proposed enhanced disclosure requirement with respect to board oversight of risk is embodied in only a single new sentence in Item 407: "In addition, disclose the extent of the board's role in the registrant's risk management and the effect that this has on the company's leadership structure,"[10] and appears on its face to be an afterthought.

However, the Proxy Disclosure Enhancement Release makes it clear that despite the brevity in the actual rules, what is intended by the rule change is a much more complete disclosure of directors' risk management activities.

Proxy Disclosure Release

The Proxy Disclosure Enhancement Release notes that companies face a variety of risks "including credit risk, liquidity risk and operational risk" and states that the proposed amendment is intended to provide information about the "role of [the] board and the relationship between the board and senior management in managing the material risks facing the company."[11]

Consistent with the requirement that there be an enhanced disclosure of board leadership structure and operation, the Proxy Disclosure Enhancement Release also states that under the proposal, discussion would be required of the manner of the board's risk oversight and the extent to which such oversight has been delegated to board committees.[12] In addition, the SEC has suggested that the board disclose to whom at the board level the person in management who oversee risk report.[13]

The Proxy Disclosure Enhancement Release also calls for disclosure of the relationship between risk and compensation.[14]

There has been a widely held perception that the financial crisis was caused in good measure by the disconnect between compensation and risk. Management is perceived to have reaped immense benefits as a result of having companies take unreasonable risks; and those benefits were retained by management while shareholder value evaporated when the risks resulted in catastrophic losses. Or, as was stated in a recent chronicle of the demise of a major financial institution, "What's the worst that could happen? We make $200 million and then we get fired."[15]

Thus, the Proxy Disclosure Enhancement Release proposes to add to the Compensations Discussion and Analysis (CD&A) a new section that "will provide information about how the company's overall compensation policies for employees create incentives that can affect the company's risk and management of that risk."[16]

It is **critical** that boards, in instituting systems of oversight, be sure that those systems are **practical** and can be followed, since **potential** exposure to **liability** could result from the **failure** to **adhere** to those oversight systems that the board adopted.

In recognition of the fact that companies may have business units with differing risk profiles, profit contributions and compensation structures, the proposed CD&A changes may require discussion of risk related compensation policy on a business unit level.[17]

The proposed changes to the CD&A also note the potential disconnect between the time periods used to measure the achievement of compensation goals and the duration of the risks assumed in connection with the achievement of those goals.[18]

Accordingly the CD&A as proposed to be amended could require a discussion of "[h]ow the registrant's compensation policies relate to the realization of risks resulting from the actions of employees in both the short and the long term, such as through policies requiring claw backs or imposing holding periods."[19]

Compensation initiatives from shareholder groups have recently addressed the alignment of management and shareholder interests and pay for performance. The proposals in the Proxy Disclosure Enhancement Release will cause a new focus on matching the maturities of incentive payments and the results of the acts that gave rise to those payments.

A further indication of the SEC's new focus on risk may be found in the disclosures that are proposed with respect to directors and nominees.

The Proxy Disclosure Enhancement Release states that expanded disclosures of the background of board members has been proposed in part because "[a]s recent market events have demonstrated, the capacity to assess risk and respond to complex financial and operational challenges can be important attributes for directors of public companies."[20]

The Proxy Disclosure Enhancement Release goes on to suggest that information about a director's or nominee's risk assessment skills is the type of background information that should be given in response to the proposed expanded disclosure requirements.[21]

Compliance Challenges

Compliance with the proposed enhanced disclosure requirements and the institution of improved oversight procedures should begin with a careful discussion and analysis of the risks to which the company is subject and the extent to which and manner in which board oversight is appropriate.

This process may be somewhat less straightforward than one would think, although there is precedent for the identification and disclosure of risk.

Disclosure of risk, as opposed to the oversight process, has long been required. Prospectuses are required to contain descriptions of the risks associated with investments.[22] In connection with permitting, and indeed, encouraging, forward looking statement, securities laws call for the disclosure of the assumptions on which forward looking statements are based and the risks that threaten those assumptions.

Unfortunately, the descriptions of risk have become somewhat routine, with insufficient attention having been paid to substance. The risk factors articulated in public filings have tended to degenerate into boilerplate renditions of everything that could go wrong in the business and the world, in an attempt to provide a shield enabling companies to make a "bespeaks caution" defense no matter what unexpected internal or external event occurs.

In addition, in overseeing internal and outside auditors, audit committees have been called upon to review risks that could affect the integrity of the financial statements.

Every audit plan that is submitted to the audit committee for review begins with an identification of the areas of greatest risk in this regard and an allocation of time and resources in the audit plan consistent with this risk assessment.

The board's determination of appropriate risk monitoring and oversight practices could start with a review of the risk factors identified in the company's public filings (notwithstanding the boilerplate language that has accreted in the risk factor section). The board as a whole should also be apprised of the risk assessments made in connection with the development of the audit plan and internal audit work program.

However, these are only starting points. Because risks vary greatly depending on the nature of a particular business, boards should regularly discuss in detail with management the nature of the risks to which various elements of the company's business are subject. Once identified, risks should be divided between those that involve operational risks and those that involve the accurate reporting of financial results and financial condition.

The risks that fall into the latter category will likely fall within the normal oversight of the audit committee. Oversight of the risks that fall into the former category will likely reside with the board as a whole or with a separate risk committee.

The SEC's increased sensitivity to risk derives from the financial crisis that led to the collapse of major financial institutions. The risks associated with the failure of those institutions were financial in nature and principally involved financial transactions and instruments that were exotic in nature, where risks were obscure and undisclosed.

However, disclosure of risk oversight pursuant to the proposed rules would not expressly be limited to financial risks. The Proxy Disclosure Enhancement Release cites credit, liquidity and operational risks as examples of risks where board risk oversight should be discussed.[23]

But many prosaic decisions, such as a determination of the extent to which inventory should be produced in anticipation of sales or the degree to which credit should be extended to customers in an effort to stimulate sales, while involving potentially significant assumption of risk, are operational decisions that are generally perceived to be the proper reasonability of management rather than the board.

Absent clarification from the SEC, the proposal to expand disclosure with respect to board oversight of risk threatens to obscure the border between management and policy oversight. It is important that the role and responsibilities of management and the board regarding risk management/oversight are clearly understood and delineated.

Notwithstanding the protestations by the SEC in the Proxy Disclosure Enhancement Release to the contrary, focusing a spotlight on risk management and oversight by the board may result in risk aversive behavior by the board which is, after all, almost entirely composed of outsiders who spend limited time on, and have a limited economic stake in that particular company. The combination of these dynamics may lead to a conservatism that is directed at capital preservation and limitation of liability rather than innovation and growth.

State Law Considerations

The disclosures that could be mandated by the Proxy Disclosure Enhancement Release may also have an impact on state law considerations.

As noted above, state law generally provides significant protection to directors in connection with risk assumption and risk management. However, increased disclosure of the oversight system may trigger assaults based upon the failure of the board to stringently follow the oversight systems that they have created; and fiduciary duty claims may be augmented by claims based on inaccurate or incomplete disclosure of the institution and operation of such systems.

It is critical that boards, in instituting systems of oversight, be sure that those systems are practical and can be followed, since potential exposure to liability could result from the failure to adhere to oversight systems that the board adopted, which are presumptively an expression by the board of the appropriate steps that it is required to take.

1. *In re Citigroup Inc. Shareholder Derivative Litig.*, 964 A.2d 106, 111-12 (Del. Ch. Feb. 24, 2009).
2. See id. at 124.
3. See id. at 130.
4. See id. at 131.
5. See *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 967-68 (Del. Ch. Sept. 25, 1996).
6. See id. at 968-70.
7. *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (interpreting *Caremark* decision).
8. See Proxy Disclosure and Solicitation Enhancements, Securities Act Release No. 9052, Exchange Act Release No. 60280, Investment Company Act Release No. 28817, 74 Fed. Reg. 35,076 (proposed July 17, 2009). Available at http://www.sec.gov/rules/proposed/2009/33-9052fr.pdf. Referred to herein as the "Proxy Disclosure Enhancement Release."
9. See Proxy Disclosure and Solicitation Enhancements, 74 Fed. Reg. at 35,102-03 (considering and asking for comments on impact of additional disclosure on the economy, competition, efficiency and capital formation).
10. Proxy Disclosure and Solicitation Enhancements, 74 Fed. Reg. at 35,108.
11. Proxy Disclosure and Solicitation Enhancements, 74 Fed. Reg. at 35,085.
12. See Proxy Disclosure and Solicitation Enhancements, 74 Fed. Reg. at 35,085.
13. See Proxy Disclosure and Solicitation Enhancements, 74 Fed. Reg. at 35,085.
14. See Proxy Disclosure and Solicitation Enhancements, 74 Fed. Reg. at 35,077.
15. Charles Gasparino, "The Sellout" (HarperBusiness, 2009).
16. Proxy Disclosure and Solicitation Enhancements, 74 Fed. Reg. at 35,078.
17. See Proxy Disclosure and Solicitation Enhancements, 74 Fed. Reg. at 35,105.
18. See Proxy Disclosure and Solicitation Enhancements, 74 Fed. Reg. at 35,105-06.
19. Proxy Disclosure and Solicitation Enhancements, 74 Fed. Reg. at 35,106.
20. Proxy Disclosure and Solicitation Enhancements, 74 Fed. Reg. at 35,082.
21. See Proxy Disclosure and Solicitation Enhancements, 74 Fed. Reg. at 35,083.
22. See Regulation S-K, 17 C.F.R. §229.503 (originally published Mar. 16, 1982).
23. See Proxy Disclosure and Solicitation Enhancements, 74 Fed. Reg. at 35,085.