

Risk Governance Will Be the Talk in Corporate Boardrooms in 2010

Managements and boards of directors of corporations had quite a ride in 2009. After facing the severe shocks caused by the Financial Crisis of 2008 and the impacts it had on business conditions, managements and boards have begun the process of assessing what risk management measures should be implemented or enhanced to better serve the interests of the corporation and its stakeholders. While the focus of boards in late 2008 and most of 2009 was liquidity risk issues, and specifically assuring that the entity had sufficient capital resources to weather the storm, as the height of the crisis passed for many, attention has turned to an assessment of other business risks. Although the "all clear" siren has not yet been heard in all quarters, 2010 brings with it a renewed sensitivity toward risk assessment beyond liquidity and capital access and how best to view risk on the management level and oversee risk management on the board level.

The responsibility of boards to oversee risk management arises primarily from fiduciary duties established under state law. Under Delaware law, applicable to many public corporations, the directors of a company owe fiduciary duties of care and loyalty to its shareholders. To satisfy their fiduciary duties, boards are required to implement policies and procedures that enable them to monitor the company's business and become informed about potential risks. In general, boards are expected to exercise informed, disinterested and good faith business judgment in seeking to identify and oversee business risks.

The Delaware Chancery Court, in *In re Caremark Int'l Inc. Derivative Litigation*, stated that director liability for a failure of board oversight required a "sustained or

systematic failure of the board to exercise oversight such as an utter failure to assure a reasonable information and reporting system exists." *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996). In that case, directors consciously ignored "red flags" indicating a systematic scheme of criminal Medicare fraud. While the threshold for liability set in *Caremark* may be high, directors should be aware that under Delaware law the failure to oversee risk management may give rise to personal liability. To avoid *Caremark* liability, boards should ensure that the company implements appropriate risk-monitoring systems.

In the 2009 case, *In Re Citigroup Inc. Shareholder Derivative Litigation*, the Delaware Supreme Court readdressed the board's role in risk oversight in dismissing claims of fiduciary breaches by directors for an alleged failure to monitor and manage risks associated with the subprime lending markets. *In Re Citigroup Inc. S'holder Derivative Litig.*, C.A. No. 3338-CC (Del. Ch. 2009). In support of its decision, the Court explained that "to impose oversight liability on directors for failure to monitor 'excessive' risk would involve courts in conducting hindsight evaluations of decisions at the heart of the business judgment of directors." The opinion also indicated a difference between a board's failure to protect against criminal or fraudulent activity and unforeseen business risk. "Oversight duties under Delaware law are not designed to subject directors, even expert directors, to personal liability for failure to predict the future and to properly evaluate business risk." While directors can be put at ease that the business judgment rule is the standard that courts will apply to their conduct, they must make sure their risk oversight duties

are met in order to avoid exposure to liability under state law.

In addition to being a sound element of internal corporate governance practices, corporate risk oversight is receiving increased scrutiny from regulators, ratings agencies and shareholders. This focus will hasten companies to move risk management higher on its already full list of priorities in 2010. In July 2009, as part of the announcement of proposed rules relating to executive compensation and corporate governance disclosure, the Securities and Exchange Commission acknowledged the role that risk and the adequacy of risk oversight played in the recent market crisis and stated it is important for investors to understand the board's role in this area. The new rules, which will become effective on Feb. 28, 2010, require companies to include enhanced and new disclosures in their proxy statements to shareholders. Specifically, the rules require new disclosures about a company's leadership structure, the board's role in the risk management process, and how a company's compensation policies and practices for employees generally create incentives that affect the company's risk along with enhanced director and nominee disclosures regarding qualifications, skills and experience.

Signs of increased attention and governmental focus on risk include the creation of the SEC's Division of Risk, Strategy and Financial Innovation in September 2009 and pending legislation introduced by Sen. Charles E. Schumer, D-NY, entitled "The Shareholder Bill of Rights of 2009," which would require all public companies to establish a standing risk committee comprised of independent directors.

Having effective risk management policies and procedures in place could impact

Risk Governance, the Talk of Boardrooms in 2010

a corporation's cost of capital as well. In May 2008, Standard & Poor's announced it would begin to enhance its credit ratings process for non-financial companies through an enterprise risk management review. The other ratings agencies have not gone as far as Standard & Poor with respect to ERM at this point. While Fitch and Moody's implicitly review risk management techniques and programs when they are rating companies, they are taking a "wait and see" attitude with respect to taking more pointed action.

In anticipation of these new disclosure requirements and other concerns, boards as a whole and individual committees have begun taking steps to enhance and approach risk issues in a more systematic and organizationally holistic manner. As a guide to assist boards in fulfilling their risk oversight role, the Blue Ribbon Commission on Risk Governance of the National Association of Corporate Directors released a report in October 2009 entitled, "Risk Governance: Balancing Risk and Reward." The Blue Ribbon Commission believes that, as a general rule, the full board should have primary responsibility for risk oversight, with the board's standing committees supporting the board by addressing the risks inherent in their respective areas of oversight. Boards should review the report and the following recommended principles as

they work, together with management and their advisors, to achieve their risk oversight objectives:

Understand the company's key drivers of success; assess the risk in the company's strategy; define the role of the full board and its standing committees with regard to risk oversight; consider whether the company's risk management system — including people and processes — is appropriate and has sufficient resources; work with management to understand

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and agree on the types (and format) of risk information the board requires; encourage a dynamic and constructive risk dialogue between management and the board, including a willingness to challenge assumptions; closely monitor the potential risks in the company's culture and its incentive structure; monitor critical alignments-of strategy, risk, controls, compliance, incentives and people; consider emerging and interrelated risks; and periodically assess the board's risk oversight processes.

In reviewing risk management policies and practices, a board must take into consideration best practices and industry standards for risk management programs. The integrated framework issued by the Committee of Sponsoring Organizations of the Treadway Commission is widely accepted and boards should be aware of its approach to oversight of enterprise risk. However, in developing appropriate risk management processes and procedures, it is important to recognize that "one size does not fit all" and that the unique circumstances and characteristics that each corporation has should be taken into account in risk identification and response.

The oversight role of the board in setting the "tone at the top" is an important step in establishing the appropriate company-specific risk management program. In the post meltdown "new world order," boards and managements that work together to establish an acceptable risk level that produces the greatest opportunity for reward will be the winners.

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