

Thinking about risk management— reflections for lead directors

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Risk and risk management are hot topics. How public company boards handle risk is being closely scrutinized. Legislation pending before Congress would go so far as to require public companies to create a separate standing committee of independent directors responsible for risk management.² The SEC recently adopted rules requiring a discussion of the board's role in risk management when a public company seeks proxies for the election of directors.³ The press has shown itself eager to find executives and directors to shame in the court of public opinion for faulty risk management. And as for the courts of law, it does not take much imagination to predict cases against executives and directors for faulty risk management.

As a result, seasoned directors now find themselves subject to countless presentations and publications lecturing them on how to manage risk. We can well understand why you might be skeptical about whether all this advice can really be helpful. After all, balancing risk and reward is what doing business is all about, and as a lead director you already have at the heart of your career success a track record of achievement in seeking reward while controlling risk.

In fact, much of the advice being offered strikes us as little more than tedious repetition of bromides and pabulum of the sort Polonius dispenses to Laertes in "Hamlet." Nonetheless, directors can ill afford to ignore a topic that has captured the attention of powerful potential antagonists. So, what's to be done, and more specifically, what role should a lead director play in this drama?

The place to start, in our view, is to recognize that the current controversy about risk management is unfolding according to a

pattern very familiar by now. Back in the 1980s, for example, a wave of takeovers— especially hostile takeovers— captured the public's attention, and boards' handling of takeover situations began to be closely scrutinized.⁴ Suddenly, when deciding whether to approve a merger, a company found it was no longer good enough just to exercise sound business judgment; you also had to be able to demonstrate to sometimes skeptical audiences that you had done so. How to do that? By following a process that self-evidently established that you had made the decision with all due care—and ensuring that that process was meticulously documented.

As another example, at the beginning of the last decade, a series of high-profile accounting scandals captured the public's attention, and boards' handling of companies' financial statements began to be closely scrutinized.⁵ Suddenly, when approving financial statements, your company found it was no longer good enough just to exercise sound business judgment; once again, you had to be able to demonstrate to sometimes skeptical audiences that you had done so. How to do that? The same way: by following a process that self-evidently established that the financial statements had been developed with all due care—and ensuring that the process was meticulously documented.⁶

Armed with this history, we see that the answer for lead directors seems straightforward. Take a page from the playbook developed for takeovers and financial statements, and help ensure that the company (and the

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² The "Shareholder Bill of Rights Act of 2009," S. 1074, 111th Congress § 5 (2009).

³ Release No. 34-61175, Final Rule: Proxy Disclosure Enhancements (December 16, 2009).

⁴ As just one example, in the case of *Smith v. van Gorkom*, 488 A. 2d 858 (Del. 1985), directors were held personally liable for money damages for the way in which they had approved the sale of their company.

⁵ The Sarbanes-Oxley Act of 2002 exemplifies the scrutiny resulting from accounting scandals at Enron, WorldCom, Tyco, Adelphia and other public companies.

⁶ Of course, legislators and regulators nudged this process along in various ways, such as by requiring management to establish and maintain "an adequate internal control structure and procedures for financial reporting," as well as requiring the company's independent auditors to attest to management's assessment of the effectiveness of internal control. Section 404 of the Sarbanes-Oxley Act of 2002.

board) follows a meticulously documented process, one that self-evidently establishes that the company's risk management has been carried out with all due care.

We can already hear the objection that such an approach will simply add costly bureaucracy where it is unneeded and unlikely to add substantive value. That's possible, but unfortunately, additional layers of bureaucracy are an inevitable incremental cost of being a public company. You can't avoid it, so your goal, as always, should be to do what's necessary as efficiently as possible, and maybe even manage to generate some net benefit as well.

How best to go about this? As a lead director, for you it would make little sense to somehow try to micromanage risk. Instead, focus on the goal of ensuring that your company has a process that self-evidently establishes that the company's risk management has been carried out with all due care. Each company needs to tailor its risk management efforts to its own circumstances, so generalities won't be of much help.

The following questions, however, are representative of those you as a lead director could think about:

- Are the company's risk management efforts—to analogize to the financial statements—both auditable and audited? That is, is there thorough documentation that provides sufficient evidence that reasonable and appropriate steps have been taken, and have senior management and the board properly overseen and monitored these efforts?

- What are the documented plans for risk management, and what are the documented procedures? As appropriate, has the board been engaged in overseeing plans and procedures for continuity of operations or crisis management?
- Do the board minutes reflect that the board paid significant attention to these topics?
- Is the board organized to address risk management issues? Is there a board committee that should be tasked explicitly with risk management? If so, should it be the audit committee, or is that committee already close to being overloaded?
- How about management—does it have the right risk management organization in place? Who's responsible? Is risk management part of the charter of the executive committee, or is there a separate, top-level risk-management committee?
- Are the processes and procedures being followed? A company would never want to find itself in the position of trying to explain why it said it would do X and then failed to follow through.
- Do the relevant lower-level employees know what to do and have the required skill sets?

Asking questions like these (and following up on the answers), not micromanaging risk, is what boards are expected to do. Establishing the right "tone at the top" is a core board responsibility, and in this area, as in so many others, lead directors can help ensure that the company is on the right path.⁷

⁷ This article first appeared in PricewaterhouseCoopers' study *Lead Directors: A study of their growing influence and importance*, April 2010