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The Role of Board of Directors in Risk Oversight in a Post-Crisis Economy

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July 30, 2010 marks the eight year anniversary of the Sarbanes-Oxley Act.[1] This landmark legislation was passed by Congress in reaction to a wave of corporate scandals which cost investors billions of dollars and shook the public's confidence in the securities markets and the leadership of corporate America. We now find ourselves immersed in the latter stages of the largest economic downturn in over 70 years, which many have attributed to a failure of corporate leadership and governance on a massive scale. Predictably, these events have spawned a renewed crisis of confidence and even more calls for reform.

In reaction, we see another round of proposed regulatory and legislative reforms aimed at helping repair the deterioration in public trust. Senior management and corporate directors face renewed criticism surrounding risk management practices and apparent failures in oversight that are considered, at least in part, to be at the root of the recent crisis. Board members have historically been viewed by some as being passive and the last line of defense against corporate wrongdoing. We know today, however, that risk management has indeed forced its way into the boardroom and that there has been a substantial change in the relationship between the overseers of public companies and their shareholders. Shareholders have brought a higher level of activism, scrutiny and influence than in the past, as well as increased expectations regarding the performance of boards acting on their behalf.

Boards should examine the importance of probing deeper into the increased risk of fraud and misconduct as part of their role in risk management oversight. Even though this was evident back in 2002 with the then-shocking corporate scandals, notably Enron and WorldCom, the economic recession has created the perfect storm for increased risk of fraud and regulatory non-compliance. Even as certain economists predict an economic recovery and turnaround for business, we will continue to see an increased likelihood of fraud and misconduct, and boards will need to understand the risks and respond accordingly.

The Role of the Board of Directors in Risk Management

It has been an established principle of corporate law for nearly 15 years that the board of directors is responsible for the informed oversight of risk management within the corporation as part of its overall exercise of fiduciary duties, but not the direct management of that risk itself. The courts have consistently held that this duty requires the board to assure that management has implemented mechanisms and procedures that are sufficient to identify, monitor and mitigate risks in the business and that there is a reporting system in place that enables the board to be kept informed as to how effectively management is dealing with those risks.[2] In addition, the board of directors must be sensitive to "red flags" that come to its attention in the course of its oversight and take steps to make sure that the corporation responds appropriately.

The failure of many financial institutions in the recent crisis to address the toxic risk inherent in complex financial instruments related to the subprime mortgage market illustrates the line that courts are prepared to draw in assigning responsibility to directors for corporate failure of risk management. In an important recent case, the Delaware Chancery Court held that directors of Citigroup were not personally liable on theories of breach of fiduciary duty for losses related to the Citigroup's exposure to subprime debt.[3] In the Citigroup case, the Chancery Court held that directors could not be held personally liable for making (or allowing to be made) business decisions that, in hindsight, turned out poorly for the corporation. Instead, the court stated that "to establish oversight liability a plaintiff must show that the directors knew that they were not discharging their fiduciary obligations or that the directors demonstrated a conscious disregard for their responsibilities such as failing to act in the face of a known duty to act."[4] In addition, in order for the plaintiffs to succeed, "a showing of bad faith is a necessary condition to director oversight liability."[5]

In finding that the director defendants had not acted in conscious disregard of their responsibilities, the court noted that Citigroup had mechanisms and procedures in place to monitor corporate risk and that the Audit and Risk Management Committee of the board met on a frequent basis to assist the board in fulfilling its oversight responsibility for risk assessment and management. In this context, the fact that in retrospect the directors should have recognized the subprime debt "red flags" in the economy generally and at Citigroup in particular did not warrant a finding that the directors demonstrated a conscious disregard for their responsibilities. The court stated, "[o]versight 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."[6] While the Citigroup case has provided a modicum of comfort to directors, the Delaware courts continue to make clear that directors can be personally liable in circumstances in which they knew that the company lacked adequate internal controls to manage risk or failed to monitor compliance with internal risk management systems or when the company was engaged in a pervasive scheme of misconduct of fraud.[7]

As boards of directors assimilate the lessons from the financial crisis, ensuring that robust mechanisms and procedures are put into place to monitor and manage corporate risk will have greater importance, both to promote sound corporate governance as well as to shield directors from personal liability.

Now, More Than Ever, There Is Increased Likelihood of Fraud Risk

Threats of fraud and misconduct are even more likely to occur as the United States and global economies move from recession into recovery because there is an alignment of the circumstances likely to give rise to fraud. Coined by criminologist Donald Cressey in 1950, the term 'fraud triangle' highlights three elements that typically need to be in place for fraud to occur. Each of these elements—incentives/pressure, opportunity and rationalization/attitude—is elevated in the current environment. Boards need to understand how these three elements may interplay within their company and take steps to ensure that management has developed mechanisms and processes to mitigate their effects.

1. Incentives/Pressure

While misconduct can, from a legal perspective, be perpetrated by a company, the steps taken to commit fraud are always the actions of individuals. It is sometimes assumed that people commit fraud mostly for personal gain. For example, people are said to 'cook the books' in order to earn large year-end bonuses. The reality is far more complex. Personal gain can be measured well beyond cash compensation. Often it is personal reputation, pressure from above or a desire to help the organization succeed, all of which can be the principal motivation. As companies emerge from the recession, pressures will shift from merely survival to meeting stability and growth expectations in the post-recession era.

Avoidance of loss, whether it be future income, job security, power or prestige is another strong motivator. The United States has witnessed the loss of more jobs than any downturn since the Great Depression. Further, those still employed feel ever more threatened. Because of factors like these, the pressure to commit fraud has increased. We like to believe that the majority of people are fundamentally honest and ethical, and as such, are not tempted by wrongful personal gain. However, when someone's livelihood is at stake, or the future of the company rests on meeting an expectation, such as obtaining a new order from a potential customer, the pressure to do the wrong thing will intensify.

2. Opportunity

Today's economic environment has created tremendous opportunities for fraud and misconduct risk. Most organizations have been forced to reduce costs without proper regard to the longer term consequences. Reductions in staffing levels may have caused gaps in the internal control system. Fewer people have been tasked with more responsibilities, often in new and unfamiliar areas. Companies have less capacity to maintain proper segregation of duties, which is a key component of internal control in relation to fraud. There are also fewer or less experienced resources to ensure internal controls are operating effectively. In these circumstances, checks and balances put in place to maintain controls may have been weakened.

In addition, as companies continue to outsource, transfer and expand operations globally to new and unfamiliar territories, they have less visibility into internal controls and business practices employed by third parties conducting business on their behalf.

3. Rationalization

The third element of the fraud triangle is the ability of individuals to rationalize the fraudulent act. For example, one might believe that "we are a good company, full of good people, and we deserve to survive." In difficult economic times, the capacity of people to rationalize fraud and corruption increases and directly connects back to the incentives and pressures employees use to justify their actions.

Global Business Risks Add to the Elevated Risk Profile

Doing business in emerging markets is the standard in today's global economy. As companies pursue growth by expanding into new markets and acquiring new businesses, the risk of exposure to corrupt third parties increases. No industry or business is immune from the risk implications of conducting multinational business and the increased focus on corruption.

In recent years, regulators and enforcement agencies have undertaken a far more proactive approach to incidents of fraud, bribery and corruption. The expectation is clear that companies must also take proactive steps in response to antifraud, anticorruption and governance programs.

In the United States, the Department of Justice (DOJ) and Securities and Exchange Commission (SEC) continue to attack corruption with increased fervor. Enforcement of the Foreign Corrupt Practices Act (FCPA) continues to proceed at a record pace. Since 2005, there have been more FCPA cases prosecuted than the number brought during the prior 28 years. In 2009, there were three FCPA-related trials and 11 companies and 33 individuals named in enforcement actions, with corporate fines totaling more than $600 million. Currently there are more than 120 active FCPA-related investigations under way. January 2010 saw the largest single investigation and prosecution against individuals in the history of the DOJ's FCPA enforcement.[8] In that case, 22 individuals were indicted for engaging in schemes to allegedly bribe foreign government officials in order to obtain and retain business.

In January 2010, the SEC also announced the creation of five newly-established specialized units within the Division of Enforcement—FCPA, Market Abuse, Municipal Securities and Public Pensions, Asset Management, and Structured and New Products—as well as the Office of Market Intelligence. The specialized units are aimed at helping its members gain in-depth knowledge of industries and regional practices to better uncover corrupt practices, as well as to conduct more targeted sweeps and sector-wide investigations. Further, the SEC announced that it will take a more active role working with its regulatory counterparts in other countries, as well as with the DOJ.

Outside of the United States, in the United Kingdom, for example, the Serious Fraud Office (SFO), a government department responsible for investigating and prosecuting serious and complex fraud, has significantly increased its conviction rate in cases brought before the courts in the past year. Further, the announcement of the Bribery

Bill in the United Kingdom signals a tougher stance on bribery and corruption. Fines against companies amounted to nearly £12 million this past year, a stark rise from £0 the year before. Generally, the momentum is growing outside of the United States as countries are criminalizing acts of corruption, establishing anticorruption bodies and creating more transparency in government operations.

Increased Expectations on Disclosure about the Board's Role in Risk Oversight

It is not surprising that the repercussions of the global economic crisis continue to bring risk management into sharper focus in corporate boardrooms. In the *2009 What Directors Think* survey conducted by PricewaterhouseCoopers and Corporate Board Member magazine, 60 percent of 1,021 respondents said unknown risks represent the greatest challenge they face as directors. Sixty-four percent of directors ranked it the highest priority after the board's core mission of profitability and shareholder value.

In December 2009, the SEC finalized rules on new proxy disclosures which will require new disclosures about the board's role in risk oversight.[9] These rules are likely to be just the opening wedge in what will be continued development of new rules and standards, which will vary according to jurisdiction and mandate higher levels of transparency and disclosure for the boards.

So, If It Does Take Legislation to Restore Public Confidence in Our Nation's Capital Markets and Force Corporate Accountability in The Boardroom and Beyond, What Is a Board to Do?

Congress has indicated that legislation is necessary to redress the causes of the economic crisis, including, potentially, requiring companies to deal with corporate risk in a more prescriptive and accountable way. The case law concludes, however, that boards of directors have the responsibility to address matters of corporate risk in a proactive manner even in the absence of legislation.[10] The following are some steps that boards of directors should be taking as the economy emerges from the current recession in order to meet their responsibilities.

1. *Review the Board's Risk Oversight Structure*

Directors should review their current risk oversight structure to determine whether it is sufficient to meet both regulatory standards and changes in the company's business strategy and its financial and operating environments. One key issue to consider is whether (and how) risk oversight is to be allocated among the various standing committees of the board, whether a separate risk management committee should be established and the extent to which risk oversight should be a primary function of the full board itself. Certain regulatory requirements independently put responsibility on board committees to address specific risk issues. For example, audit committees are typically tasked with oversight of the effectiveness of the corporation's internal controls over financial reporting and disclosure under the Sarbanes-Oxley Act.[11] New SEC regulations effective for 2010 require the compensation committee to assess whether a company's compensation policies and practices lead to excessive risk-taking by employees. Depending upon the size and complexity of a company's business, an investment committee, a technology committee or a regulatory affairs committee might be charged with oversight of other specific elements of corporate risk. However, whatever the committee structure, a board should not let risk oversight exist only in committee silos but should instead take a holistic approach, either at the full board level or through a risk committee of the board, in order to develop a view of corporate risk that is well integrated with and prioritized to mesh with the overall corporate strategy.

2. *Task Management to Reassess the Corporate Risk Management System*

Changing business strategies and internal restructurings during the economic downturn have changed the risk profile of many companies. Reductions in staffing levels and changes in job descriptions may have created gaps in the corporate risk management system that need to be addressed. Redeployment of resources, new strategic directions, overseas expansion, business outsourcing or acquisitions may expose the company to risks that it did not confront prior to the downturn. As a result, the board should use task management to reassess the mechanisms and procedures that are presently in place to determine whether they are sufficient on a going-forward basis to identify, monitor and mitigate areas of particular risk sensitivity. Assuring that such systems are in place is the fundamental responsibility of directors in complying with their fiduciary duties in the area of risk oversight.

3. *Assure That the Information Flow to the Board Is Regular and Transparent*

The board cannot rest on its laurels having satisfied itself that an appropriate risk management system has been implemented by management. Directors have a legal obligation to keep themselves informed about how *effectively* these systems are functioning and, most importantly, whether they have identified "red flags" that warrant heightened attention. To this end, directors should set aside one or more meetings during each year at which risk oversight is on the agenda. This annual review cycle should include an assessment of the corporation's ethics policy as well as reports from the members of management who have operational responsibility for internal compliance systems. In addition, under recent amendments to the Federal Sentencing Guidelines, an effective compliance and ethics program must expressly authorize those persons with operational responsibility for compliance to have direct and personal access to the board or an appropriate committee to raise matters of concern.[12] To create an effective information flow to directors, the board must foster open relationships with management personnel responsible for corporate activities that are most sensitive to significant risk.

4. *Align Risk Management with Business Strategy*

Successful business execution involves a balancing of risk and reward to achieve corporate goals; thus, the objective of an effective risk management system, and of board oversight of that system, is not to eliminate risk altogether but to make sure that the tolerance for risk, and the means to manage that risk, is consistent with achieving those goals. This requires that risk oversight must become a part of the overall corporate strategic planning process at the board level and that all levels of the corporation must develop a consistent approach to risk in day-to-day decision-making.

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[1] Pub. L. No. 107-204, 116 Stat. 745 (2002), codified as amended in various sections of 11, 15, 18, 28 and 29 U.S.C.).

[2] *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).

[3] *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106 (Del. Ch. 2009).

[4] *Id.* at 123.

[5] *Id.* (emphasis omitted).

[6] *Id.* at 131 (emphasis omitted).

[7] *American Int'l Group, Inc. Consolidated Derivative Litig.*, 965 A.2d 763 (Del. Ch. 2009).

[8] Press Release, U.S. Department of Justice, Twenty-Two Executives and Employees of Military and Law Enforcement Products Companies Charged in Foreign Bribery Scheme (January 19, 2010), *available at* http://www.justice.gov/opa/pr/2010/January/10-crm-048.html.

[9] Regulation S-K Item 402(s), 17 C.F.R. § 229.402(s).

[10] See *Stone v. Ritter, supra*; *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

[11] Sarbanes-Oxley Act § 301, 15 U.S.C. § 78j-1.

[12] U.S. Sentencing Guidelines Manual Section 8B2.1(b) (2009).