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GIBSON, DUNN & CRUTCHER LLP's LEGAL INSIGHTS

Risk Management and the Board of Directors

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Many contend that the success of a capitalist economic system requires a meaningful and ongoing share of failures. The straightforward premise is that, only by allowing the free market to determine winners and losers, and only by enabling future entrepreneurs and investors to learn from past failures and to adapt to changing circumstances, can the best and most competitive solutions be found. Stated differently, capitalism requires risk of failure.

What public opinion and our political system reflect, however, is an open hostility to risk when the consequences of business failures become widely felt. We see this dichotomy in today's headlines as demands for greater regulation suggest a widespread belief that there is too much risk in our current economic system.

Whatever one's economic and political views, the role of the board of directors in addressing "risk" and "risk management" has become a hot topic. What has recently occurred in this arena and what is being proposed? And what might be the implications for assessing director effectiveness or even determining legal satisfaction of fiduciary duty?

The trend is clear: "risk management" will soon become a highlighted portion of corporate governance.

Since 2000, the first bolus of governmental activity addressing the board's responsibilities for "risk" was the Sarbanes-Oxley Act of 2002. Arising out of the scandals at Enron, WorldCom and elsewhere, the Sarbanes-Oxley Act heavily focused on addressing the "risk of fraud." The costs to public companies have been enormous, especially those related to implementation of Section 404 and internal controls. But our political system's response should have been fully expected as the risk of fraud and economic short-cuts resulted in widespread losses and a public view that the risk had to be somehow addressed.

The more recent economic crisis has driven public opinion to focus on somewhat different risks, including leveraging and other risk-taking endeavors. And so we should fully expect that, apart from a special regulatory scheme aimed at financial institutions, we will see efforts to have boards of directors more aggressively address the perceived problem of "excess risk" generally.

In July 2009, the SEC proposed amendments to its disclosure rules that, if adopted, will hurry this process along. (Comments on the proposals were due September 15, 2009 with the SEC's hope to implement amendments in time for the 2010 proxy season).

One amendment specifically requires disclosure about the board's role in the company's overall risk management process, including with respect to credit, liquidity and operational risks. As the SEC states in the Background of its Release:

> "Given the role that risk and the adequacy of risk oversight have played in the recent market crisis, we believe it is important for investors to understand the board's, or board committee's role in this area."

Some predict that many companies will form yet another standing board committee -- a "Risk Management" Committee -- in response to this corporate governance "call to action."

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Another proposed SEC amendment encompasses two lightning rods -- risk and compensation. A company would be required to discuss and analyze its compensation policies for all employees if those policies may create material risks to the company. The SEC noted:

> " . . . we anticipate that companies will need to consider the level of risk that employees might be encouraged to take to meet their incentive compensation elements."

Another proposed amendment calls for expanded disclosure about directors' specific experience, qualifications and skills. It seems no accident the SEC begins a sentence on this topic with:

> "The types of information that may be disclosed include, for example, information about a director's or nominee's risk assessment skills and any past experience that would be useful to the company . . . "

Even more recently, the SEC announced in September 2009 the formation of a new Division called the "Division of Risk, Strategy and Financial Innovation." This new Division is charged with performing long-term analysis, identifying new developments and monitoring trends in the financial markets, all with an eye toward the SEC's regulatory activities vis a vis systemic risk.

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Will traditional doctrines of a director's fiduciary duty change in light of these developments? Fiduciary duty standards are typically determined under relevant state law. In a Delaware case earlier this year, plaintiffs alleged that the Citigroup directors breached their fiduciary duty by failing to monitor and manage the risks associated with Citigroup's exposure to the subprime market. Because this was an alleged breach of "duty of loyalty" for failing to provide proper oversight, plaintiffs sought to hold the Citigroup directors personally liable as Delaware law permits personal monetary exculpation for breaches of duty of care, not duty of loyalty. The Delaware Chancery Court dismissed these counts on the basis that the duty of oversight is not, absent bad faith, intended to subject directors to personal liability for failing to properly anticipate business risk.

But the warning light should be on for all directors. With the concept of "risk management" becoming a core part of the duties of a board of directors, a new and increasing legal, investor and public opinion focus can be expected. History will judge whether this focus, and whether placement of this responsibility on the board of directors, will achieve the legitimate goals of a better understanding and management of inherent business risk, or whether the result will be a defensiveness against all risk that saps the entrepreneurial strength of our economy.

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