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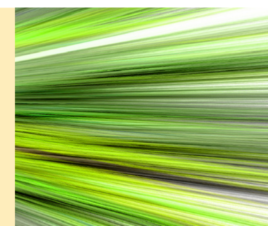

January 2010

Board's Role in Enterprise Risk Oversight[1]

Priya Cherian Huskins,[2] Partner

INTRODUCTION

Has the Securities and Exchange Commission implemented a new risk oversight disclosure rule that might potentially be a bonanza for the plaintiff's bar? On December 16, 2009, the SEC released a plethora of amendments to the public company disclosure rules.[3] These amendments include newly mandated disclosure concerning the board's role when it comes to the risk oversight of a company. This article will discuss the new rule—including the additional risk the new rule may bring to a company and its directors and officers. The article will also outline the steps that boards should take right now in order to be in the best position possible to comply with the new rule and avoid potential new liabilities.

THE PROBLEM TO BE SOLVED

The financial melt-down of late 2008 was cataclysmic, so no one can be surprised by calls for enhanced disclosure concerning the board's role in a company's risk management process. Driving this new rule is the near-universal belief that the inadequacy of risk oversight played a central role in the recent market crisis. Indeed, the current political and economic environment made the adoption of this new disclosure rule in time for the 2010 proxy season a certainty.

THE SEC NEWLY REQUIRED DISCLOSURE ON THE BOARD'S ROLE IN RISK MANAGEMENT

New disclosure about the board's role in enterprise risk oversight is only a very small part of the total package of new rules that the SEC released on December 16, 2009. Most of the new rules address topics like compensation disclosure and compensation philosophies, including the impact of compensation structures on risk taking. However, buried deeply within this set of new rules, is the following:

> In addition, disclose the extent of the board's role in the risk oversight of the registrant, such as how the board administers its oversight function, and the effect that this has on the board's leadership structure.[4]

The SEC was blunt about the reason for this proposed disclosure, noting in light of "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."[5] The disclosure is intended to give investors key insights into how a company's board perceives and manages a company's risks.

The new rule applies to proxy statements, registration statements filed pursuant to the Securities Act of 1933, and the annual report filed pursuant to the Securities Exchange Act of 1934.

CONCERNS ABOUT THE RULE

Some of the concerns with the new risk management disclosure are obvious. For example, the rule is likely to encourage lengthy, unhelpful, boiler-plate responses. Perhaps the biggest concern, however, should be the law of unintended consequences. More specifically, every time the SEC expands a company's disclosure obligations, it

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[1] *This article is an update to an article by Priya Cherian Huskins and published by Bloomberg Finance L.P. (November 2009).*

[2] *Priya Cherian Huskins, Esq., is a partner at Woodruff-Sawyer & Co., a full-service commercial insurance brokerage headquartered in San Francisco, CA. Priya focuses on Director and Officer Liability Risk and its mitigation, including through D&O Insurance. Priya can be reached at 415-402-6527 or phuskins@wsandco.com.*

[3] *Proxy Disclosure Enhancements, Release Nos. 33-9089; 34-61175; IC-29092; File No. S7-13-09], 17 C.F.R. pts. 229, 239, 240, 249,and 274.*

[4] *Id. at page 118.*

[5] *Proxy Disclosure and Solicitation Enhancements, 74 Fed. Reg. 35,076 (proposed July 10, 2009) (to be codified at 17 C.F.R. pts. 229, 239, 240, 249, 270 and 274) at 35,085.*

potentially creates another opportunity for the plaintiffs' bar to sue a company—and its directors and officers—for getting the disclosure wrong.

Here is an example of a suit that could be brought by disgruntled shareholders who decide with the benefit of hindsight that they do not like a company's risk management disclosure. Imagine a diligent board that properly discloses that it has undertaken a rigorous process to assess the company's enterprise risks and ways to mitigate these risks, concluding that it has adequately addressed the company's risks. Subsequently and unexpectedly, the company experiences an event that results in a number of employees being killed in a company owned and operated facility in China. The company immediately discloses the human tragedy, and also discloses that this terrible situation will cause the company to miss its earnings guidance for the quarter. As a result, the company's stock drops precipitously.

Seeing the precipitous stock drop, the company's shareholders—represented by aggressive, contingent-fee lawyers—sue the company's directors and officers. The plaintiffs allege that the board's reassurance that it had assessed and monitored the company's enterprise risk was false. The plaintiffs will seize on the risk management disclosure as a potential material representation that they can allege as the cause of the stock price drop when the "truth" was revealed. Boards and officers potentially face unlimited personal liability in this kind of disclosure suit. When they are sued, their companies of course suffer as well.

BOARD ACTIONS TO TAKE NOW

Here are some steps that boards can take to mitigate the risk of risk disclosure-related law suits. For some boards, taking steps to optimize their ability to respond to the new risk disclosure rules may mean enhancing their risk management focus. No matter what their practices before, all boards, will want to ensure that there is good documentation of the board's work on risk management issues.

1. **Clarify what risk management means for your company.** "Risk management" as a term can be so broad that it has no meaning. If a company has not done so before, now is the time for a company to determine the framework it wants to use to think about risk. The framework the company is using should be tested to make sure that it is capturing the risks the company is facing today, and is likely to pick up risks the company faces in the future. Creative thinking, including brainstorming on the business impact of everything from global warming to an aging demographic, is appropriate here.

2. **Clarify ownership of risk management at the board level.** Governance experts differ on whether risk management belongs at the committee level or at the board level. If it resides at the committee level, there is dispute over whether the audit committee should (also) own this responsibility, or whether it belongs with a separate risk management committee. The "right" answer is likely different for different companies. Whatever your company decides, a formal decision should be made—and the reasons for the ultimate decision should be clearly articulated—in anticipation of having to disclose the rationale in SEC filings.

3. **Formalize the board's involvement in the company's risk management process.** Most boards likely discuss risk management issues at every meeting. After all, risk is integral to any discussion of a company's business. While this will and should continue, boards should now also put on the agenda a specific time for management to give a formal risk management presentation. Management's presentation should be a broad one that includes the risk concerns of senior management. It should also include the input that can be had from folks at the company such as corporate and litigation counsel and the company's insurance risk manager. This sort of formal presentation should happen at least once a year, if not more often. The agenda formality may feel clunky at first, but it will ultimately facilitate a better record of the board's risk management activities in the board meeting minutes.

4. **Spend time understanding what is being done—and not being done—to mitigate enterprise risk.** A company's risk management process of course includes identifying various risks and quantifying the probability and impact of these risks. In addition to understanding this part of the process, the board should understand what risks the company is taking steps to mitigate as well as what risks it is not mitigating. The latter—what risks the company has decided not to address—should be as carefully considered as any other part of the risk management process.

An example of this type of discussion is risk transfer in the form of insurance. The board should understand which risks are insurable and which are not. It should also understand when a company's capital is best used to insure a particular risk, and when it is not. A company's skilled insurance broker can support the board's discussion of these matters. In the alternative, this kind of discussion may well lead to the board's hiring an independent consultant who can help it assess the company's insurance programs, where any gaps may exist, and whether the pricing is appropriate. While the board is at it—and in light of the potential new disclosure suits that may be coming down the road—this is also a good time to make sure the company's director and officer liability insurance policies are well constructed. Insurance coverage attorneys and independent insurance brokers who offer risk management consulting services are in the best position to do this kind of work.

5. **Ensure that board meeting minutes are adequately and accurately descriptive.** Memories fade; board meeting minutes last forever. When management makes its risk presentation to the board, management's materials should reflect its understanding that these materials will become part of the board meeting minutes. The materials will also be scrutinized as part of the record if the board and the officers are ever sued over the company's risk management disclosure issues. Also, while the board's questions and ensuing discussion should not be recorded verbatim in the minutes, the minutes should accurately reflect the robust nature of the discussion the board should be having.

6. **Start drafting the new SEC-required disclosure early.** Boilerplate language neither delivers on a board's duty to provide clear disclosure to its shareholders, nor will it serve as an effective shield should shareholders later decide to sue the company, the board and its officers over disclosure issues. Boilerplate will also not be an effective rebuttal to an SEC enforcement action. The best way to avoid the boilerplate trap is to start working early on what you want your company's disclosure to say. Starting early allows enough time for the hard work of creating effective shareholder disclosure. It allows for the time it takes to involve outside counsel and insurance experts in the process. Perhaps most importantly, starting early also provides a cushion of time that might be needed by a board that—perhaps even through the disclosure drafting process—realizes that it needs to do more work on behalf of its shareholders in the area of the company's risk management process.

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