# Time For A Risk Check-Up

**by Robert Barker and Patrick R. Dailey**

**While the corporate liability climate has been largely stable for the past few years, looks can be deceiving. Some liability threats have actually increased, and "unknown unknowns" continue to surface. Following is a boardroom process to uncover liabilities that may lie ahead for your company, and ways your board can help steer away from them.**

The boardroom litigation front has been disarmingly quiet for a few years. Securities litigation and legal actions against directors reached a low point in federal filings after the passage of the Public Securities Litigation Reform Act of 1995. The rate of new class-action filings in the first half of 2013 increased over the prior six-month period after two years of a decreasing trend line. Median settlements trended up only slightly over 2012.

Directors should take advantage of this calm before the next storm to consider how to avoid the oversights that pose the greatest threats to them. Failure to monitor the unknown risks (or to consider whether there may be "unknown unknowns") could lead to financial loss as well as reputational damage.

In light of the changing landscape, has your board reviewed the steps needed to minimize director liability? More important, is your board taking steps beyond the basics to minimize the risk of overall loss and perform more effectively? Here is a checklist of some things you should consider doing to ensure that your board is operating at its peak:

☐ ***Use an annual board self-assessment process.*** Most boards and committees are required to conduct an annual self-assessment each year to determine how the board is performing against its own—and external—standards. For public companies these days, there is no dearth of opinion on how the boards are performing. Your proxy solicitors have access to the ISS and Glass-Lewis reports, and you should familiarize yourself with those external assessments and the standards used by those agencies. However, the board will want to make its own assessment against its own standards.

The board may want to consult with counsel to try to protect the confidentiality of its self-assessment. The desire for the protection of privilege should not prevent the company from asking itself hard questions in the assessment process, but you and your advisors should be aware of when privilege is important.

The litigator's rule of thumb is that a director faces one hour of deposition time for every page of handwritten notes. It is far better to make sure that you know and are following the appropriate rules of document preparation and preservation in conducting board evaluations.

**A board self-assessment that is self-congratulatory is worse than no self-assessment all. It enervates the board and leads to complacency.**

Board self-assessments are typically perfunctory. While we do not recommend that boards rate themselves numerically or give themselves grades, boards should not conduct an assessment without coming up with ideas for doing things better—or at least differently. A self-assessment that is self-congratulatory is worse than no self-assessment all, because it enervates the board and leads to complacency.

To have an effective self-assessment process, directors should use executive sessions—without management, and with only independent advisers present—to discuss amongst themselves how they think they are doing. These are hard conversations to have, and they do not come about in the ordinary course of board meetings. They are necessary for a board trying to stay at its peak.

The self-assessment process can be an onoing process through the year, and each executive session

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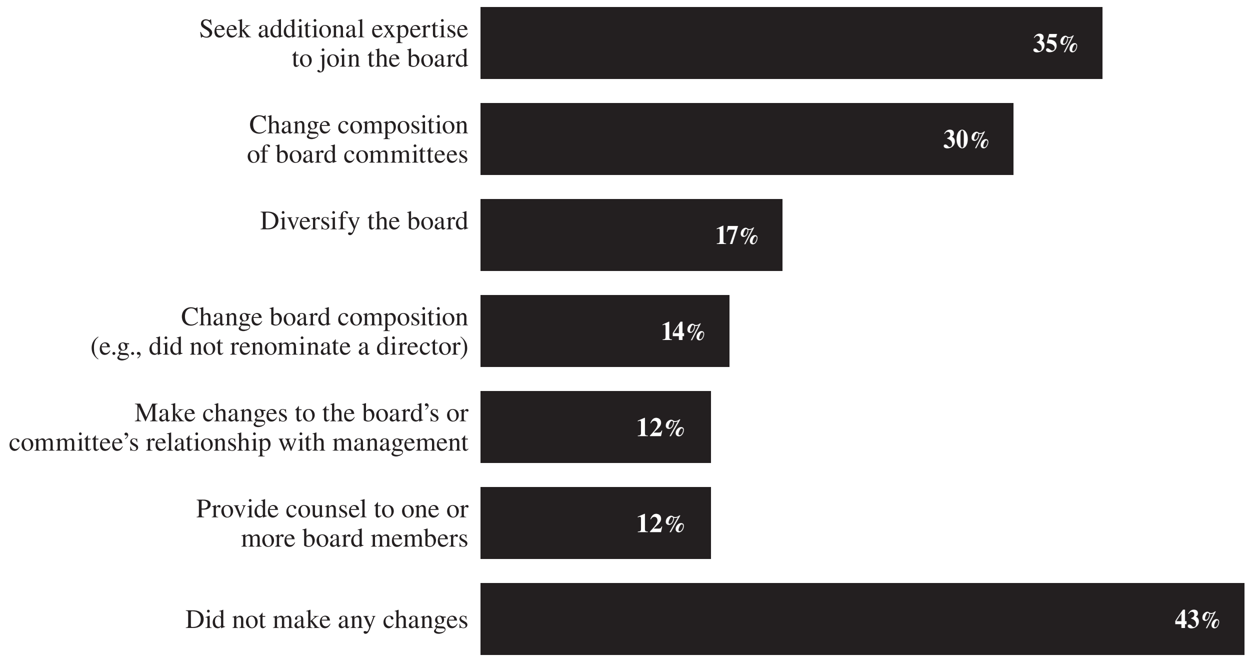
## Assessing Your Needs

### In Response To Your Last Board Evaluation, Did You…




*Source: PricewaterhouseCoopers Center for Board Governance Annual Director Survey*

should reference the take-aways from the last self-assessment. These conversations should be planned by the independent chairman or the lead director. There are many ways for directors to have these discussions in a safe setting—telephone conferencing services are available as well as videoconferencing services for committees or small boards that want to meet in a manner that facilitates an open discussion.

☐ ***Use an annual risk-assessment process.*** Most boards, committees, and some stock exchanges require the management team to conduct an annual risk assessment. For some industries, the risk assessment process is mandated by regulation. As part of that review, directors need to focus on how their oversight of the company improves management performance and business results.

There is little guidance in the stock exchange rules on how this risk assessment should be performed, so use outside advisors to assist you, at least in the first instance and periodically thereafter. Bear in mind the need for legal privilege for issues that could be the subject of litigation.

All companies are subject to some regulation, and board members should review the compliance procedures used by their management team to ensure that the company is in compliance with applicable law. For example, if facilities are subject to periodic inspections, what do those inspections measure, and how does management prepare? If a company is subject to a compliance agreement with a regulator, how is that agreement being monitored? What compliance failures have affected your competitors?

Target Corporation's 2013 failure to protect its credit card users from hacking, for example, might have been predicted based on a similar hacking incident at a competing retailer six years earlier. A board should ask, "How can we protect ourselves from the incidents that we see at other peer companies?"

At least once a year, directors should also discuss the reports of all analysts covering the company, which should be available to the directors as they are published. Boards should seek independent sources of information with respect to the company's performance—industry news stories, credit reports, etc. These outside verifications give directors insight into potential issues that may not be visible in management reports.

**Laws and regulation today have forced boards to deal with another potential liability: failure to comply with their own policies.**

Directors should be aware of the risks they are taking when they affirmatively exercise their judgment, as well as the potentially unknown risks that may arise from *failing* to exercise oversight. Sometimes these encompass matters that have never risen to the board level.

Recent laws and regulations may open up another potential for liability for directors—failure to comply with their own policies. For example, J.C. Penney's Corporate Governance Guidelines imposed an obligation on its directors to keep confidential "the… deliberations of the board and its committees, and the discussions and decisions between…directors."

How binding are such provisions on directors affiliated with activist investors who see a need for public criticism? Whether state corporate laws would create enhanced duties for directors from language like this, it seems obvious that boards need procedures to ensure that they "walk the talk" in their committee charters and guidelines.

☐ ***Use the board calendar.*** The corporate secretary keeps a board calendar of perfunctory items that must be scheduled to comply with regulation. You can use that calendar for more substantive matters, like assessing risks and scheduling time to discuss strategy and effectiveness.

Ram Charan, in his book *Boards that Deliver,* suggested a "twelve-month agenda" to schedule discussions about compliance, operating effectiveness, strategy, people, and urgent concerns. In some companies, a compliance review can be scheduled at a certain board meeting, but some companies may need a compliance review quarterly, while others can schedule reviews over a multi-year period. Oversight of compliance is one of the most important reviews if the board understands its role as that of protecting the investment of the shareholders.

By using the board calendar effectively, a board can stay on course with its mission of providing oversight for, and protecting the interests of, the shareholders. A board's primary job is to make sure that the managers are asking the right questions with respect to operating effectiveness and strategy, and then assess the effectiveness and value of the management team in the process. Board members may want to discuss strategy at every meeting but directors are usually not going to have as much information about the markets in which the company operates as management themselves.

Scheduled tasks should be more than just a "check the box" analysis, and should consciously focus on what your board is doing to protect the company and its shareholders. The board should take whatever time it needs to make a decision. How many boards actually decide to extend the time of a meeting beyond the allotted time? Outside of a company crisis, how many boards actually set meetings independent of the time scheduled by management?

Having a calendar that focuses on the basic duties of the board ensures that directors' focus will protect their wealth and their reputation as directors. If followed, a calendar will create a record that the directors have fulfilled their duty of care to the company.

☐ ***Review your indemnities and insurance.*** The company will naturally have standard-issue insurance for its directors and officers. Boards should review those D&O policies with an outside expert, someone who can work with the company's broker, at least three months before renewal every year. Review the "parade of horribles" with a broker, preferably one who is thinking thoughtfully about the trends discussed above. Liabilities arise when the actions of the board disappoint a corporate constituent, who is almost always an investor.

A little role playing may be helpful. For example, how does your board monitor conflicts of interest to ensure that the business judgment rule protects the action of directors for all board decisions? Each director should be able to explain to his or her own counsel how the board addresses conflicts of interest when they arise. How would a regulatory investigation create individual liability for directors? What do your investors expect?

Think through the issues that come out of your review. Do not ask for a simple yes-or-no answer. For example, do not ask, "Is the pension fund complying with regulations?" Instead, ask, "What should we know as directors to learn if our pension commitments are vulnerable to future investment risks?"

In highly regulated industries, such as financials, health care, or businesses that engage in government contracting, do a "deep dive" into how compliance is handled. Once every five years may be appropriate for some sectors, but others require an annual review.

Specialists can confirm whether you have insurance for SEC investigations, foreign investigations, derivative actions, environmental liabilities, and the like. However, even the best coverage will still have deductibles, usually around $100,000. This may not be reimbursed by the company in some situations, such as bankruptcy, allegations of serious misconduct, or regulatory bars to indemnification. Directors whose interests are aligned may arrange for common counsel with a joint defense agreement, and share the costs of capital and any up-front costs or deductibles. Even so, those costs can be significant.

For additional peace of mind, consider whether your company offers written indemnification agreements with its directors. Do those indemnification agreements spell out when you can seek the advice of separate counsel?

As you review the policies with your counsel and brokers, consider whether you should have counsel on retainer who is up-to-speed with the company and its business. Counsel representing directors and other members of your team in a crisis will be more likely to be effective if they are not scrambling for data in a compressed timeframe.

☐ ***Protect a culture of excellence.*** All boards have a culture. Some boards share a culture that simply reinforces the *status quo*, and are indecisive and ineffective. Other boards have a dynamic culture that promotes honesty, curiosity, and adherence to an ethical standard that is greater than the personality of any one board member, or any member of the management team.

**A board of directors is a team that creates excellence when members challenge each other to strive for better results from the team.**

While it is important for you as a director to protect yourself and your reputation, you will find your task easier if your entire board shares this goal. A board that is working toward defining a culture of excellence will find it far easier to do so if it promotes a culture of excellence in the board itself. A board culture does not often improve through regulatory dictates or corporate governance best practices, but by board members challenging each other to strive for better results.

A board of directors is a team, and teams work best when they are comprised of people with different educational and functional backgrounds. Still, diversity on a board can result in conflict or misperceptions of intentions. That could lead to dysfunction unless the directors trust one another and have a common sense of purpose and corporate values.

Boards must periodically review their team dynamics and explore whether all the members share that commonality. Such a review can involve working with an expert on group dynamics or simply face-to-face meetings. Board members may not need to participate in "rope courses" or other survival exercises together, but they should review how their work together enhances their chances of survival as a board. Explore instances when failure to use the input from all the members led to increased risk, loss or missed opportunities.

A board that is constantly asking itself "How can we do better?" is a board that will produce better returns for its shareholders, better products for its customers, and an environment of excellence for its management team and employees. ■