Refocusing the Role of Directors in Light of the Current Economic Downturn

Article contributed by: Bart Friedman and Ted B. Lacey, Cahill Gordon & Reindel LLP

In light of the current economic downturn, the question has been raised as to how the focus of directors should shift to comport with the present needs of the corporations on whose boards they serve. While this question is complex and presents an opportunity for reassessing the role of corporate directors, three areas warranting heightened attention and concern stand out as significant and particularly relevant in the current economic environment. First, board members must ensure that their perception of acceptable risk and that possessed by management is congruent. Second, members of corporate audit committees must be sensitive to the pressure placed on management in respect to earnings reports released during fiscal downturns. Third, members of corporate compensation committees must be aware that shareholders will demand that management also feels the impact of declines in share value. Increasing attention to these areas, while only several of the matters of concern that directors must focus on in the current economic downturn, would have a significant impact.

As corporations' financial results continue to suffer in the current economic downturn, it is essential that directors and management possess a shared understanding of what level of risk is acceptable to take on in the pursuit of improved results. Directors need to be aware that management is under increased investor and market pressure to improve results, and this pressure may lead to strategic decisions that could have unfortunate outcomes for the corporation. While directors still must resist micro-managing corporate officers so as not to stifle potential opportunities for growth, they must concurrently scrutinize the trends in management decision-making to determine whether risks being assumed by their corporations are at acceptable levels. With this increased focus, directors can ensure that the corporations they serve are not being unwittingly led down a dangerous path.

Just as directors must be sensitive to whether management is taking on excessive risk in order to improve financial results, they must also be attuned to whether management is influencing financial results and reporting to disguise poor performance. Such efforts can take a number of forms ranging from improper revenue recognition practices, public disclosures which fail to give balanced reports of both positive and negative trends in a business or unreasonably delaying making tough decisions for fear of triggering a precipitous drop in stock price. For example, of the 344 accounting fraud cases brought against companies by the SEC from 2000 to 2006, 41% stemmed from improper revenue recognition schemes, by far the most prevalent basis for such fraud cases.[1] The frequency of these improper revenue recognition cases hit its peak in 2003 following the downturn that began with decline of the tech boom. In one case involving four former executives of AOL Time Warner Inc., the SEC charged that the individuals had participated in a scheme to artificially inflate the company's reported online advertising revenue by more than $1 billion.[2] All four executives agreed to settle the action.[3] As financial results head downward in this difficult economic environment, directors must be keenly aware of these past problems when reviewing financial reporting so as to ensure that the internal audit function and external auditors are given strong support.

Even if directors are successful in properly evaluating the risk and reporting pressures bearing on management, they still must deal with a dramatically different climate in the management compensation arena. With shareholders experiencing dramatic declines in their equity investments, members of compensation committees must realize that management compensation is an area on which shareholders are intensely fixated. As a result, directors cannot simply base their compensation awards to management on a simple survey of competitors. Directors must ask the tough questions about the actual performance of the executives within the company and thoroughly analyze the company's performance data when setting compensation. Specifically, directors must consider whether executive compensation has

© 2009 Bloomberg Finance L.P. All Rights Reserved.

been sufficiently sensitive to performance in a corporation's recent history. In the current economic climate, it is essential that this link be strong in order to assure shareholders that there is accountability within the corporation. Where compensation arrangements are allowed to exist where pay and performance remain disconnected, "institutional investors may view such arrangements as a strong signal that the executives or directors are relatively insensitive to shareholder interests. These investors may become less likely to support the incumbents should a hostile takeover or a proxy fight occur. In this manner, through the operation of the market for corporate control, outrage over compensation can impose a penalty on managers and directors."[4]

While the job of a corporate director is surely more difficult and complex today than it was only a short time ago, keener attention to the concerns discussed above is an effort well worth making. Through such focus, directors can play a critical role in guiding our corporations through this troubled market and out to what will hopefully be improved conditions in the not too distant future.

Bart Friedman, a partner with Cahill Gordon & Reindel LLP, advises leading corporations, boards of directors, audit committees and officers and directors of publicly-held companies in corporate matters and securities transactions and in corporate governance and enforcement challenges, including those arising under Sarbanes-Oxley. Earlier in his career, Bart was Special Counsel and then Assistant Director at the SEC, where he handled trading practices issues, legislative initiatives and liaised with certain branches of government. He is based in New York, and may be reached at bfriedman@cahill.com.

Ted B. Lacey, a corporate associate at Cahill Gordon & Reindel LLP, practices in the areas of corporate governance and in the Firm's transaction-focused practice advising on a variety of financing transactions and mergers and acquisitions. He is based in New York, and may be reached at tlacey@cahill.com.

---

[1] Deloitte Financial Advisory Services LLP. "SEC Enforcement Activities and Trends: What If Your Company Is Next?" 2008.
[2] *Id.*
[3] *Id.*
[4] Bebchuk, Lucian and Fried, Jesse. "Stealth Compensation Via Retirement Benefits." Discussion Paper No. 487 of Harvard Law School's John M. Olin Discussion Paper Series. August 2004. p.5.