SPECIAL GOVERNANCE WATCH: BRT STATEMENT ON THE PURPOSE OF A CORPORATION

CLE Materials

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““# Cleary M&A and Corporate Governance Watch

Mergers and Acquisitions, Corporate Governance, Shareholder Activism

The Purposes of a Corporation and the Role of the Board

By Leslie N. Silverman, Arthur H. Kohn & David Lopez on August 21, 2019

Monday’s Business Roundtable Statement on the Purpose of a Corporation is significant, mostly because it opens the door for more discussion of the idea of “corporate purpose”. While there are many ways that conversation could go, there are good reasons to believe the discussion will lead to a shift in corporate governance towards more authority and responsibility for corporate boards. Specifically, boards will be expected to lead on corporate social responsibility issues.

Andrew Ross Sorkin sums up the background nicely in his article in Tuesday’s New York Times[1], including his summation that “for whatever progress may have been made Monday, it is hardly clear the debate is over.” There are two issues, in particular, touched on by Sorkin that deserve quick supplementation.

First, a reason that Milton Friedman would say in 1970 that “there is one and only one social responsibility of business– to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game,” and that the Business Roundtable would say in 2019 that companies “share a fundamental commitment to all of our stakeholders,” is that in Friedman’s time we had a functioning federal government (think Great Society programs of the mid-1960’s, the National Environmental Policy Act of 1970 and the Employee Retirement Income Security Act of 1974), and today we have a dysfunctional federal government[2]. If you are optimistic that our political governance will improve markedly in the short term, then you should expect the corporate purpose debate to cool off soon. Friedman, by the way, was very explicit about the premise underlying his view of corporate social responsibility; namely, that corporate social responsibility involves the diversion of corporations for the performance of political functions: “[the corporate executive] is in effect imposing taxes, on the one hand, and deciding how the tax proceeds shall be

spent, on the other. . . . The doctrine of 'social responsibility' involves the acceptance of the socialist view that political mechanisms, not market mechanisms, are the appropriate way to determine the allocation of scarce resources to alternative uses."

Second, the Council of Institutional Investors ("CII"), in responding negatively to the Business Roundtable's Statement, is relying on an argument that bends to the pressure of close inspection. On the one hand, CII could not credibly take a position against corporate social responsibility, insofar as its members have been very vocal supporters of that idea, in an active way. For example, for the third year in a row in 2019 environmental and social proposals were a majority of all shareholder proposals filed under Rule 14a-8. On the other hand, CII's membership is threatened by a return to the era of corporate managerialism, in which corporate executives had discretion to determine corporate policy with relatively little consultation with shareholders or oversight by boards. CII tried to thread the needle by strongly linking corporate social responsibility to long-term shareholder value, while kind of preserving the idea of shareholder primacy: "To achieve long-term shareholder value, it is critical to respect stakeholders, but also to have clear accountability to company owners." Echoing Friedman, CII argues that to the extent that social responsibility cannot be linked to stock price performance, the corporate responsibility issues are in the sphere of government, not business: "It is government, not companies, that should shoulder the responsibility of defining and addressing societal objectives with limited or no connection to long-term shareholder value." The principal problem with that thread-the-needle solution is that the link between long-term shareholder value and corporate social responsibility may not be strong enough, at least at this time, to fill the current vacuum.

Where are we headed? A stakeholder perspective, as contemplated by the Business Roundtable's Statement, does not necessarily involve any legally binding obligation. What the CEOs "commit" to in the Business Roundtable's Statement is almost certainly not legally enforceable under a contract theory. As for corporate fiduciary law, CII is probably right when it argues that "accountability to everyone means accountability to no one." Proposals have been made for creating a framework for legal responsibility in a world of stakeholder-focused governance. One such proposal would have each corporation have a statement of its corporate purpose included in its by-laws, with board fiduciary responsibility to justify their decisions in light of their statements of corporate purpose, to the satisfaction of the courts.**[3]**

A more likely landing point for the current debate is a strengthening of the role of directors, on whose shoulders can be placed responsibility for balancing shareholder interests with social interests. To bear that responsibility, the resources and commitment of boards would be increased.**[4]** The result

could perhaps retain the idea of shareholder primacy, but with increased attention to stakeholder perspectives – and, specifically, social and environmental issues – accompanied by disclosure related to those issues, as well as a heightened standard for board attention to the risks of inaction.[5] The corporate law of Delaware, and likely most other states, could accommodate a new balance along those lines without any fundamental change to the law, because of the deference accorded to directors by the business judgment rule. Thus, directors would be encouraged to give heightened attention to stakeholder interests and would be protected under a traditional business judgment rule analysis from second guessing by the courts. Plaintiffs challenging corporate social responsibility efforts would have to plead facts showing that a corporate decision being challenged was not undertaken because of the potential benefit to shareholders that results from the intangible value of the corporation acting as a good corporate citizen. The board would be well positioned to assume that role as representatives of shareholders, who can be voted out by them, and not as corporate managers with the same types of entrenchment risks and incentives that Friedman's shareholder primacy theory was designed to address.

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[1] Andrew Ross Sorkin, "How Shareholder Democracy Failed the People (at **https://www.nytimes.com/2019/08/20/business/dealbook/business-roundtable-corporate-responsibility.html?action=click&module=Top%20Stories&pgtype=Homepage**).

[2] We do not use the term "dysfunctional" as an aspersion on any political party or philosophy, but rather to describe a generalized inability of elected officials of all philosophies to engage in consistent dialogue and compromise that leads to the passage of thoughtful legislation designed to address the many existing issues faced by the country.

[3] Colin Mayer, "Prosperity – Better Business Makes the Greater Good" (Oxford University Press, 2018).

[4] As contemplated by Ronald J. Gilson & Jeffrey N. Gordon in their recent article entitled "Board 3.0 – An Introduction," Business Lawyer, Vol. 74, p. 351, 2019.

[5] As contemplated by our recent notes entitled "Caremark and Reputational Risk Through #MeToo Glasses" (at **https://www.clearymawatch.com/2018/05/caremark-reputational-risk-metoo-glasses/**) and "Not So Sweet: Delaware Supreme Court Revives Caremark Claim, Provides Guidance On Directors' Oversight Duties" (at **https://www.clearymawatch.com/2019/06/not-so-sweet-delaware-supreme-court-revives-caremark-claim-provides-guidance-on-directors-oversight-duties/**).

Cleary M&A and Corporate Governance Watch

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BR Business Roundtable

CORPORATE GOVERNANCE

Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans'

AUG 19, 2019

Updated Statement Moves Away from Shareholder Primacy, Includes Commitment to All Stakeholders

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WASHINGTON – **Business Roundtable today announced the release of a new Statement on the Purpose of a Corporation signed by 181 CEOs who commit to lead their companies for the benefit of all stakeholders – customers, employees, suppliers, communities and shareholders. (https://opportunity.businessroundtable.org/ourcommitment/)**

Since 1978, Business Roundtable has periodically issued Principles of Corporate Governance. Each version of the document issued since 1997 has endorsed principles of shareholder primacy – that corporations exist principally to serve shareholders. With today's announcement, the new Statement supersedes previous statements and outlines a modern standard for corporate responsibility.

“**The American dream is alive, but fraying**,” said Jamie Dimon, Chairman and CEO of JPMorgan Chase & Co. and Chairman of Business Roundtable. “**Major employers are investing in their workers and communities because they know it is the only way to be successful over the long term. These modernized principles reflect the business community’s unwavering commitment to continue to push for an economy that serves all Americans.**”

“**This new statement better reflects the way corporations can and should operate today**,” added Alex Gorsky, Chairman of the Board and Chief Executive Officer of Johnson & Johnson and Chair of the Business Roundtable Corporate Governance Committee. “**It affirms the essential role corporations can play in improving our society when CEOs are truly committed to meeting the needs of all stakeholders**.”

Industry leaders also lent their support for the updated Business Roundtable Statement, citing the positive impact this commitment will have on long-term value creation:

“**I welcome this thoughtful statement by Business Roundtable CEOs on the Purpose of a Corporation. By taking a broader, more complete view of corporate purpose, boards can focus on creating long-term value, better serving everyone – investors, employees, communities, suppliers and customers**,” said Bill McNabb, former CEO of Vanguard.

“**CEOs work to generate profits and return value to shareholders, but the best-run companies do more. They put the customer first and invest in their employees and communities. In the end, it’s the most promising way to build long-term value**,” said Tricia Griffith, President and CEO of Progressive Corporation.

"**This is tremendous news because it is more critical than ever that businesses in the 21st century are focused on generating long-term value for all stakeholders and addressing the challenges we face, which will result in shared prosperity and sustainability for both business and society**," said Darren Walker, President of the Ford Foundation.

The Business Roundtable Statement on the Purpose of a Corporation is below and the full list of signatories is available **here (https://opportunity.businessroundtable.org/ourcommitment)**.

Statement on the Purpose of a Corporation

Americans deserve an economy that allows each person to succeed through hard work and creativity and to lead a life of meaning and dignity. We believe the free-market system is the best means of generating good jobs, a strong and sustainable economy, innovation, a healthy environment and economic opportunity for all.

Businesses play a vital role in the economy by creating jobs, fostering innovation and providing essential goods and services. Businesses make and sell consumer products; manufacture equipment and vehicles; support the national defense; grow and produce food; provide health care; generate and deliver energy; and offer financial, communications and other services that underpin economic growth.

While each of our individual companies serves its own corporate purpose, we share a fundamental commitment to all of our stakeholders. We commit to:

- Delivering value to our customers. We will further the tradition of American companies leading the way in meeting or exceeding customer expectations.

- Investing in our employees. This starts with compensating them fairly and providing important benefits. It also includes supporting them through training and education that help develop new skills for a rapidly changing world. We foster diversity and inclusion, dignity and respect.

- Dealing fairly and ethically with our suppliers. We are dedicated to serving as good partners to the other companies, large and small, that help us meet our missions.

- Supporting the communities in which we work. We respect the people in our communities and protect the environment by embracing sustainable practices across our businesses.

- Generating long-term value for shareholders, who provide the capital that allows companies to invest, grow and innovate. We are committed to transparency and effective engagement with shareholders.

Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities and our country.

BR Business Roundtable

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September 2019

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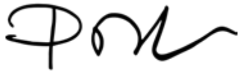

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Council of Institutional Investors®
The voice of corporate governance

FOR IMMEDIATE RELEASE
August 19, 2019

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Council of Institutional Investors Responds to Business Roundtable Statement on Corporate Purpose

Washington, D.C., August 19, 2019 —The Council of Institutional Investors (CII) today expressed concern on a new Business Roundtable (BRT) statement on the purpose of a corporation. The statement undercuts notions of managerial accountability to shareholders, in CII's view.

The Council has a productive relationship with BRT that has included discussion on corporate "stakeholder" obligations, but we respectfully disagree with the statement issued by the BRT earlier today. The BRT statement suggests corporate obligations to a variety of stakeholders, placing shareholders last, and referencing shareholders simply as providers of capital rather than as owners.

CII believes boards and managers need to sustain a focus on long-term shareholder value. To achieve long-term shareholder value, it is critical to respect stakeholders, but also to have clear accountability to company owners.

Accountability to everyone means accountability to no one. BRT has articulated its new commitment to stakeholder governance (which actually resurrects an older policy view) while (1) working to diminish shareholder rights; and (2) proposing no new mechanisms to create board and management accountability to any other stakeholder group.

Americans depend on strong companies not only as employees and communities, but also as owners, including through pension funds and other retirement holdings. CII supports putting capital to its best use for long-term performance, which includes addressing stakeholder contributions to that objective. It is government, not companies, that should shoulder the responsibility of defining and addressing societal objectives with limited or no connection to long-term shareholder value.

CII has welcomed BRT's earlier focus on long-term value for shareholders, including recent BRT steps to combat excessive focus on the short-term, notably by discouraging company provision of quarterly earnings guidance. We do believe it is a challenge for boards and executives to keep their focus on the longer-term. But clearly companies with strong leadership have shown an ability to do so, particularly where they provide shareholders with thorough disclosure and clear articulation of long-term strategic vision.

Much of the discussion on "stakeholder" governance focuses on individual companies, and seems to downplay or ignore the role of markets. Shareholders have a very particular role in allocating (and re-allocating) equity capital. Public equity generally is highly liquid, and no doubt company managers often are frustrated by a sense that they are vulnerable to changes in company valuation that can be rapid, as investors reassess company prospects. While we appreciate that CEOs do not like to feel constrained and subject to market forces, nothing in the BRT statement will change this real-world dynamic of public equity markets.

While it is important for boards and management to have and articulate long-term vision, and sustain focus on the long-term strategy where they have strong conviction, a fundamental strength of the U.S. economy has been and continues to be efficient allocation of equity capital. If "stakeholder governance" and "sustainability" become hiding places for poor management, or for stalling needed change, the economy more generally will lose out.

The Council of Institutional Investors (CII) is a nonprofit, nonpartisan association of pension funds, other employee benefit funds, endowments and foundations, with combined assets of about $4 trillion. Our associate members include non-U.S. asset owners with more than $4 trillion in assets and a range of asset managers with more than $35 trillion in assets under management. CII is a leading voice for effective corporate governance, strong shareowner rights and vibrant, transparent and fair capital markets. CII promotes policies that enhance long-term value for U.S. institutional asset owners and their beneficiaries.

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Board 3.0 – An Introduction

Ronald J. Gilson & Jeffrey N. Gordon

Working Paper No. 602

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Board 3.0 -- An Introduction

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ABSTRACT

This paper sketches out the case for a new board model, Board 3.0, as an option for public company boards. The goal is to develop a model of *thickly informed, well-resourced, and highly motivated* directors who could credibly monitor managerial strategy and operational skill in cases where this would be particularly valuable. Unlike the present board model of *thinly informed*, *under-resourced, and boundedly motivated* directors, Board 3.0 directors could credibly defend management against shareholder activist incursions, where appropriate, with institutional investor owners. Similarly, such directors could find a place in extremely complex enterprise, such as finance, where the costs of business failure are profound. One inspiration for Board 3.0 is found in private equity, in which the high-powered incentives of the PE sponsor have produced a different mode of board and director engagement that seems associated with high value creation. Porting over some of its features to the public company board offers a fresh starting point. The present public board model is an organizational experiment begun approximately 40 years ago, which replaced a prior organizational form that had fallen short. There is no reason to think the present public company board model is the "end of history" for corporate governance. The world of private markets, venture capital and private equity, have made effective use of alternative board models. Our goal is to bring some of that governance experimentalism to public companies. Expanding public company board models with Board 3.0 may avoid the need for corner solutions, such as dual class common structures or take-private transactions. A new public company board option will strengthen the capacity of public markets to facilitate capital formation and will thus aid financial inclusion by sustaining the number of public companies.

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Given the restrictions associated with the symposium in which our essay appears, we are intentionally light on the footnotes that would point to the extensive literature on the corporate governance topics that we touch on here. We appreciate comments received from colleagues at a Columbia Law School Blue Sky Lunch; a presentation to the Advisory Board of the Millstein Center for Global Governance and Corporate Ownership, a "Boards" Pre-conference at Columbia Law School in 2016, the 2015 Pileggi Lecture at the Widener School of Law, and Jack Coffee, Victor Goldberg, and Leo Strine. We particularly appreciate the time and candor of the private equity parties we interviewed.

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By Ronald J. Gilson and Jeffrey N. Gordon***

I. Introduction

This essay sketches out the case for a new model for public company boards: Board 3.0. The now-dominant public board model is an organizational experiment begun approximately 40 years ago, which replaced a prior organizational form that had fallen short. The current model, the "monitoring board," is dominated by part-time independent directors who are dependent on company management for information and are otherwise heavily influenced by stock market prices as the measure of managerial performance. We have seen a recurrent pattern of monitoring boards composed of talented people that fail to effectively monitor. Nevertheless, when companies fall short in business acumen or legal obligation, we have also seen a recurrent response: place even greater demands on the very boards whose structural inadequacies gave rise to the monitoring failure, most systematically, the millennium accounting scandals that gave rise to Sarbanes-Oxley and the 2008 financial crisis that gave rise to Dodd-Frank.

The problem we see is the inability of the monitoring board model to keep up with changes in the business of the corporations that board structure was supposed to monitor. It simply does not scale.

Consider J.P Morgan & Co. in 1976, the publication year of Mel Eisenberg's iconic book that framed the monitoring board model,[1] and then compare it to JPMorgan Chase today. The company's size, the complexity of the markets in which it functions including the explosion of derivative products and markets, the compliance demands on the company while also satisfying its own business success and satisfaction of its legal obligations, and the skills necessary to understand today's international capital and product markets all have grown exponentially since 1976.

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1. Melvin A. Eisenberg, The Structure of the Corporation: A Legal Analysis (1976).

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Figure 1
JPMorgan Chase: 1976 to 2017

	1976	2017	% increase
Net Revenue	$1.8 billion	$99.6 billion	5,533%
Number of Employees	9662	252,539	2,614%
Number of Countries	16	60	375%

Source: Form 14A and Form 10K fillings of JPMC and its predecessors. In constant dollars, the 1976 figure would be $7.8 billion and the percentage increase would be 1277%.

Figure 1 illustrates that surge, using the rise in its net revenue, number of employees, and number of countries in which JPMorgan Chase operated from 1976 to 2017 as a rough proxy for the growth in the magnitude, complexity, and extent of regulation of the business that its board was charged to oversee.[2]

Over the period, JPMC's board transformed itself in response to pressure to adopt the monitoring board model. Board composition shifted from a quite large advisory board (twenty-four directors in 1975) to a monitoring board of eleven or twelve directors by 2002. Received wisdom had become that a small board monitors best.[3] Except for a short-term bulge to handle the "social issues" involved in a large merger,[4] board size at JPMC then remained roughly steady. By the end of the period, all directors except for the CEO were "independent." Although JPMC outperformed many banks during the financial crisis, it was hardly immune from unnerving risk management oversight failures, as compellingly illustrated by the so-called "London Whale" episode, in which the bank suffered massive losses, $6.2 billion, on what was purportedly risk-reducing portfolio hedging.[5] There is no easy way to scale the current board model to meet the new business reality. The number of board members cannot be increased without reducing the board's ability to function. Adding committees may (finitely) leverage directors' time and technical expertise but also creates silos within the board. One path, expectations of deeper engagement that require much more time, will necessarily lead to much higher director compensation, which has been regarded as in tension with independence, given the traditional role management has played in director selection.

The particular business problem that urgently calls out for a new board model is created by the interaction of two developments: the dramatic shift toward

2. During the 1976 to 2017 period, the growth was assisted by significant acquisitions: J.P. Morgan & Co. and Chase Manhattan merged in 2000 (prior to the J.P. Morgan-Chase merger, Chemical Bank had merged with Manufacturers Hanover in 1991 and Chase Manhattan with Chemical Bank in 1996), acquired Bank One (and thereby JPMorgan's current CEO, Jamie Dimon) in 2004, and Bear Stearns and Washington Mutual in 2008 as part of the Financial Crisis cleanup of failed financial industry participants.

3. *See* David Yermack, *Higher Market Valuation of Companies with a Small Board of Directors*, 40 J. FIN. ECON. 185 (1996).

4. The Bank One/JPMC merger referred to in note 2.

5. *See* Arwin G. Zeissler, Daisuke Ikeda & Andrew Metrick, *JPMorgan Chase London Whale: Risky Business* (Yale Prog. on Fin. Stability Case No. 2014-2A-V1) (Mar. 11, 2015), https://ssrn.com/abstract=2577827.

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majoritarian institutional ownership of most large public companies and the rise of a new form of financial intermediary, the activist hedge fund. The consequence is that, to an unprecedented extent, even the largest public companies (and their management teams) are subject to credible proxy contests by shareholder activists objecting to management's strategic vision or operational competence.[6] On the present board model, well-meaning directors are nonetheless *thinly informed, under-resourced, and boundedly motivated.* Such directors are poorly situated to defend management against what is at least a credible business counter-vision. The consequence is that institutional investors may themselves resolve through their votes strategic disputes between the activist and company management rather than defer to the board's assessment of the company's existing strategy. Commonly, such disputes are framed in the incumbents' inability to advance the stock price relative to peers and over time. Managements object that stock prices are flawed measures of value creation, especially for strategies that cannot be fully revealed for competitive reasons or are otherwise undervalued, at the least in the short run, by the market's valuation metrics. The consequence of activist pressure, say the friends of management, is value destruction through the sacrifice of long-term value creation that cannot be valued by the market at the time an investment must be made.

The task that confronts public corporations is to effectively respond to the dramatic changes since the emergence of the monitoring board and so better equip the board to function in a radically different business environment, including the greater scrutiny associated with the reconcentration of share ownership. Our goal is to frame a board model composed of a workable number of *thickly informed, well-resourced, and highly motivated* directors who could credibly monitor managerial strategy and operational skill in cases where this would be particularly valuable. Unlike the present board model, Board 3.0 directors could, where appropriate, credibly defend management to institutional owners in the face of shareholder activist challenges, or credibly insist that management take seriously activist proposals that the board thinks warrant due consideration. Similarly, such informed, resourced, and motivated directors could find a place in extremely complex enterprises, such as finance, where the costs of business failure are profound both to the shareholders and to the economy more broadly.

To be sure, the symposium in which this article appears allows us only broadly to sketch the premises that underlie Board 3.0 and how it might be implemented. But our account does allow us to initiate discussion of what problems a new model needs to address, and how a new structure might do so. If nothing else, we can establish that a needed successor to the current board model will reflect at least as significant a change as did the current model in relation to its predecessor.

One inspiration for Board 3.0 is found in private equity, in which the high-powered incentives of the private equity sponsor have produced a different

6. We trace these developments in Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Re-valuation of Governance Rights*, 113 Colum. L. Rev. 863 (2013).

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mode of board and director engagement that seems associated with high value creation. Porting over in part, and adapting in part, some of the private equity board governance features to the public company, offers a fresh starting point. There are plainly observable reasons to think the present public company board model is hardly the "end of history" for corporate governance; it is hardly a large step to recognize that governance has to evolve to match the radical changes in the markets in which public corporations operate. The world of private markets, venture capital, and private equity, all post-1976 developments, have made effective use of alternative board models. Our goal is to bring some of that governance experimentalism to public companies.

Importantly, a more credible Board 3.0 model may solve some of the serious information asymmetries faced by some public companies: Full disclosure of strategic plans may deprive companies of first-mover advantages in competitive markets and, more generally, may put public companies at competitive disadvantage to private companies. Yet markets cannot give value to plans that are not yet revealed, which makes the firm vulnerable to activist shareholder pressure and may push firms to second-best strategies. Board 3.0 can address this problem by generating credibility with the institutional investors that the board can strike a workable balance between the claims that capital markets may in some circumstances be myopic and that in others managers may be hyperopic, convinced that their own strategy will succeed if only they and it are given even more time. This tension is baked into the publicly held corporation. Board 3.0 can also avoid the need for corner solutions, such as dual class common structures or take-private transactions, which focus on only one of the two directions in which impaired vision can cause poor strategic choices.

II. The Rise of Board 2.0

The current board model for public companies has its genesis in academic theorizing in the 1970s that subsequently found acceptance among the elite corporate bar and the Delaware courts. This model, "Board 2.0," conceived of the board as principally "monitoring" the performance of managers in corporations characterized by diffuse shareholder ownership, which separated ownership from control. Such an ownership pattern would induce "rational apathy" on the part of shareholders when it came to monitoring managerial performance and behavior. Thus, monitoring boards, acting for shareholders, were the necessary complement to widely distributed ownership. In this Board 2.0 model, boards were to be populated by "independent" directors, not economically beholden to the corporation and therefore not under the economic thumb of the CEO.[7]

7. Understandably, the Delaware courts' analysis of independence has not taken into account deep social relationships between independent directors and management. While the judicial analysis simply denies the impact of rich social networks, the outcome is not necessarily wrong. Unlike economic relationships, social ties and their strength, while perhaps observable, may be very difficult to verify even to sophisticated courts. A recent case, *Sandys v. Pincus*, 152 A.2d 124 (Del. 2016), illustrates the unusual circumstances (co-ownership of an airplane) that would make such social relationships verifiable.

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At a minimum such independent directors would constitute a majority of the board; ideally, all directors other than the CEO would be independent.

The monitoring board's predecessor, Board 1.0, was an "advisory" board model, in which the directors were part of the CEO's team: other corporate officers ("insiders"), trusted confidants of the CEO personally, and "affiliated" directors, commonly linked to the company's outside law firm, its bank, or its investment bank.[8] Board 1.0 was the traditional model of the public company board; it certainly was dominant in the 1950s and 1960s.

The model came under attack for its inability to constrain managerial malfeasance in three particular respects. First, the bankruptcy of Penn Central, a bona fide blue chip until it collapsed, showed that the Board 1.0 model could produce a board that was simply unaware of the business challenges at the firm. Contemporary assessments of directors' attention to a company's affairs were withering.[9] Second, the spread of the conglomerate merger, which produced unwieldly businesses that were beyond the managers' capacity adequately to manage, showed that directors were unable to constrain managerial appetites for bigger empires.[10] Directors seemed unaware that in many cases the "economic logic" consisted principally in the manufacture of "earnings" through the manipulation of accounting conventions.[11] Third, the so-called "questionable payments" scandal of the 1970s, in which many firms were found (or preemptively confessed) to illegal campaign contributions in the United States and bribes paid abroad, showed that Board 1.0 directors could not be counted upon to constrain or even know about management's frank illegal behavior—that was not their job.[12]

The failings of the Board 1.0 model helped shape the Board 2.0 alternative, the monitoring board composed of independent directors. Over the period of the 1970s–2000s, this monitoring model was strengthened in three dimensions: First, expectations shifted from a board with a simple majority of independent directors to one composed almost exclusively of independents except for the CEO. Second, the tests of economic "independence" became increasingly rigorous, focusing particularly on the absence of any other economic relationship with the firm. And third, boards came to (or were required to) employ a robust

8. This evolution is traced in Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 Stan. L. Rev. 1465 (2007).

9. *E.g.*, Myles L. Mace, Directors: Myth and Reality (1971).

10. The current travails of General Electric, widely seen in the past as the best managed conglomerate, illustrates the problem. Thomas Gryta & Ted Mann, *GE Powered the American Century—Then It Burned Out*, Wall St. J. (Dec. 14, 2018), https://www.wsj.com/articles/ge-powered-the-american-centurythen-it-burned-out-11544796010 (tracking the company's history from its previous highs to its current difficulties).

11. *See, e.g.*, Peter Steiner, Mergers: Motives, Effects, Policies 103–19 (1975) (showing how mergers that show earnings created through "pooling" accounting could enhance a company's apparent growth rate and thus purportedly increase the stock price); Patrick Hopkins, Richard Houston & Michael Peters, *Purchase, Polling and Equity Analysts' Valuation Judgments*, 75 Acct. Rev. 257 (2000) (application of purchase-pooling conventions can distort analysts' assessments).

12. This understanding of the limited directors' role underpinned *Graham v. Allis-Chalmers Manufacturing Co.*, 188 A.2d 125 (Del. 1963), which held that directors had no duty to undertake compliance monitoring.

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committee structure that would facilitate focused attention to specific board monitoring tasks. By the end of the period, most large public companies had an audit committee, a compensation committee, and some version of a nominating-governance committee that addressed the performance of the board itself.

The driving forces in this evolution were several. First, CEOs came to see the legal advantage of independent directors in helping to fend off unsolicited takeover bids, because the Delaware courts were more likely to validate "just say no" defensive measures if approved by an independent board. Similarly, the courts came to permit "special committees" composed of independent directors to take control of and dismiss shareholder derivative litigation. CEOs thus embraced the presence of independent directors, who could hold off two of management's most feared predators: hostile bidders and plaintiffs' lawyers.

Second, institutional investors—whose ownership stakes steadily grew over the period—strongly lobbied for staunchly independent boards as better protecting their interests. If they would lose the performance pressure of the control market, the institutions wanted directors who would promote shareholder interests in the boardroom.

Third, regulatory and compliance demands grew over the period, which led to the committee structure and strengthened independence standards. In particular, the fallout from the millennium accounting scandals, exemplified by Enron and WorldCom, led to mandatory independence criteria imposed by the Sarbanes-Oxley Act and subsequent stock exchange listing requirements.

In the wake of these developments, Board 2.0 came to have a strategy for compliance: set up an audit committee that will review the work of outside auditors and to whom the internal audit function would report. If other compliance failures become manifest, set up a special committee that will review an investigation conducted by outside lawyers. This strategy of reliance on outside experts has been carried over, with less success, to executive compensation: set up a compensation committee that will "review" the work of outside compensation consultants.

When it came to oversight of the company's strategy and operational performance, however, Board 2.0 was left somewhat at sea. Typically, the board meets bi-monthly; management plays a dominant role in shaping the board's agenda and selecting/assembling the information for board review. The board has no easy way to generate "deep dive" board meeting presentations into the firm's business and strategy that might inform a critical perspective on the management account; the board is "under-resourced" for this purpose. In light of the time constraints of the decidedly part-time directorship model and the lack of an alternative information channel, Board 2.0 directors are "thinly informed." Indeed, the main source of their non-management information flow about the company is the stock price, which is informed by the diligent information gathering and digesting by securities analysts and other market participants. Thus, the firm's stock price performance, year-to-year and in comparison to peers, has become the key metric for Board 2.0 directors, not only because it corresponds to some idea of shareholder welfare but because it provides a thinly informed director the most reliable measure of management's success. Finally, as monitoring obligations via regulation

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expanded, less time was left for the board to become deeply knowledgeable about the company's business. Board time is finite and new responsibilities consumed time that previously had been available for non-regulatory efforts.[13]

The tie between Board 2.0 and reliance on the stock price bears emphasis. One limitation of the Board 2.0 model is that the stock price is the only measure of performance that 2.0 directors can have confidence in. That is, such directors know that there is much they do not know, and know further that management is in control of the information flow to the board. Directors also know that others, including analysts, may well know more/have thought more about the firm's economic performance/prospects. In the absence of deep, unfiltered knowledge about the firm, why *shouldn't* such directors evaluate management on the stock price performance? The point of Board 3.0 is to imagine a director model in which directors could credibly *to themselves* and to majoritarian owners assert that the stock price is missing a critical element of expected future realizations.

Another limiting element of the Board 2.0 model is the way that directors are "boundedly motivated." Although "best practice" is to deliver a significant fraction of director compensation in the form of stock-based pay, commonly 50 percent, and to require directors to accumulate an ownership stake during their period of board service, the absolute level of director compensation is not high, nor does it markedly change in response to the director's performance.[14] Yes, a director's ownership stake will increase in value with the stock price, but even stellar performance as a director will not lead to additional compensation for the next period. Moreover, the typical director of a large public company is near the end of a distinguished career at another firm, or retired. This pattern predicts risk aversion; the downside of reputational embarrassment for the director generally exceeds the potential financial gains. This may produce better incentives for compliance oversight but it also may limit the director's motivation to support business risk-taking, including resisting an activist's challenge when it might be best to do so. Moreover, the part-time nature of the commitment is a feature, not a bug, for such a director: either he/she has another, full-time job, or, if retired, is in primary pursuit of leisure.

The Board 2.0 model has not remained static since its inception. Board autonomy has generally strengthened over the period, in part because of structural features such as a "lead director" for the common case in which the CEO also wishes to remain as board chair; providing a leadership role for one independent director has become the price of the double title for the CEO. Similarly, we have seen the increasing role of the "nom-gov" committee in evaluating director candidates alongside the CEO's input. Directors have become more confident in their monitoring prerogatives and third parties, like outside auditors, have become more attuned to their role in identifying corporate fraud. Perhaps the model is "Board 2.1." Nevertheless,

13. This was illustrated at a board retreat one of us attended. The company's general counsel circulated a year's board meeting agendas with the portion of each meeting day spent addressing regulatory oversight blocked out. The limited time left for strategy discussion was visually apparent.

14. *See* John Armour, Jeffrey Gordon & Geeyoung Min, *Short-Changing Compliance* (ECGI Working Paper, Sept. 2018), https://ssrn.com/abstract=3244167.

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the fundamental dynamic persists: the board typically will be reactive rather than proactive; directors are information- and time-constrained and have bounded motivation in the intensity of their engagement and the risk-taking they will support.

Changing capital market conditions have altered the governance environment within which boards operate, putting pressure on the standard Board 2.0 model. The re-concentration of share ownership into the hands of institutional investors has potentiated the rise of a new intermediary: the activist hedge fund.[15] Commonly focusing on companies whose stock price has underperformed, the activists come forward with criticisms of the company's strategy and/or management's operational skill. This challenge, framed in governance terms as a proxy contest for board representation, is typically accompanied by an elaborate external critique and proposals for change and may include selling the company at a time management thinks unwise. An activist's credibility will be supported by a substantial investment in the target company and an observable track record of prior shareholder engagements.

The limitations of the Board 2.0 model mean that directors may be less well-informed about the company than the activist and so the directors' belief about current and future strategy will have less influence with the institutions that are the company's majoritarian owners. The concern is that at least in some cases the stock prices will not be indicative of the company's performance and prospects because there are legitimate business reasons for withholding information that would otherwise be impounded in the stock price. Some business strategies or product innovations depend on lengthening the period of first-mover advantage; premature disclosure would reduce shareholder value. Or the market price may reflect uncertainty about management's capacity to execute a complicated strategy. Board 2.0 directors cannot credibly offer assurances—"trust us, we have deeply reflected upon the company's strategy in the context of its competitive environment, capability, and resources"—that would persuade institutions to reject for the time being the activists' contentions.

Activism battles often are cast as the struggle by management to pursue long-term strategies in the face of pressure to maximize in the short term. This framing misses the governance shortfall in Board 2.0. Just because management says its long-term strategies are first best but just not (yet) appreciated by the market doesn't make it so: the market may be myopic but management may be hyperopic. Directors under the current board model are generally not in position to evaluate and validate strategies that the market does not already understand, and the relevant parties, including the majoritarian institutional owners, understand this.

III. THE PE "PORTCO" BOARD MODEL—ON THE WAY TO BOARD 3.0

What form might an alternative director model take that could deliver credible support to management in the face of a serious challenge by activists? Or, to flip the point, that would drive additional performance whether or not the activ-

15. For elaboration, see Gilson & Gordon, *supra* note 6.

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ists have arrived? Or provide higher quality monitoring in an environment of increasing business complexity? Based on the private equity governance literature and interviews at some significant PE firms, we sketch out a board model that is commonly used in the governance of private companies held in the PE portfolio, "portfolio companies" or "portcos."[16] The exact mix of techniques varies across PE firms and even within a particular firm but includes a common core: a small board (rarely more than six) that includes one or two "deal" people (who identified and shaped the economic logic of the acquisition), one or two "operators" from the PE firm, who focus on the details of the portco management's formulation and execution of strategy, one "outside" director who has industry-specific expertise, perhaps from a stint as a senior executive in a public company, and the portco CEO. The PE firm-designees to the portco board are mid-career; they have a large financial and career stake in the portco's success. The operator will engage with the CEO on a frequent basis, as well with as those who report to the CEO. The board meets frequently, sometimes weekly, depending on the business situation, and the agenda is set by the operator in light of what seems the most important business questions. The operator marshals the portco-specific information that is relevant to the board's discussion. Most important, the portco board has the capacity to fire the CEO and alter the strategy.

One board member will be, in effect, the lead director, who will drive the PE firm's engagement with the portco. This person will have substantial personal financial gain/loss on the line, not only from portco-specific payoffs in an IPO or private exit but also in terms of his/her career within the PE firm. This "empowered lead director" can marshal the full analytic capacity of the PE firm to assess the strategic and operational questions facing the portco. Analysts from the PE firm will be able to access portco-specific information in their work. The annual time commitment that the PE senior staff and analysts will devote to monitoring the portco's performance is in the thousands of hours.

The core elements of this board model result in directors who are *thickly informed, well-resourced,* and *highly motivated*.

The value of this governance model seems established by the overall success of PE's most experienced and systematic practitioners. Early in the history of PE, a large fraction of the gains came from "financial" strategies. Michael Jensen fa-

16. The relevant literature includes: Viral Acharya, Oliver Gottschlag, Moritz Hahn & Conor Kehoe, *Corporate Governance and Value Creation: Evidence from Private Equity*, 26 Rev. Fin. Stud. 368 (2013); Viral Acharya, Conor Kehoe & Michael Reyner, *Private Equity vs. PLC Boards in the U.K.: A Comparison of Practices and Effectiveness*, 21 J. Applied Corp. Fin. 45 (2009); Andreas Beroutous, Andrew Freeman & Conor F. Kehoe, *What Public Companies Can Learn from Private Equity*, McKinsey on Fin. (Winter 2007); Ugur Clikyurt, Private Equity Professionals on Public Firm Boards (Mar. 2015) (unpublished manuscript available at https://ssrn.com/abstract=2586466); Francesca Cornelli & Oguzhan Karakas, Corporate Governance of LBOs: The Role of Boards (May 2012) (unpublished manuscript available at https://ssrn.com/abstract=1875649); Paul Gompers, Steven N. Kaplan & Vladimir Mukharlyamov, *What Do Private Equity Firms Say They Do*?, 121 J. Fin. Econ. 449 (2016); Ronald W. Masulis & Randall S. Thomas, *Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance*, 76 U. Chi. L. Rev. 219 (2009), and Simon Witney, The Corporate Governance of Private Equity-Backed Companies (2017) (unpublished PhD thesis at the London School of Economics), http://etheses.lse.ac.uk/3557/.

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mously identified the capturing of excess free cash flow through the fixed payments of interest and principal as a major source of leveraged buyout gains.[17] The threat of bankruptcy would limit management's ability to divert such cash to negative net present value projects. Another early "financial" story related to the use of LBOs as a mechanism to break up unwieldy conglomerates that produced negative synergies. Selling off the various subsidiaries to related-industry acquirers would fund the retirement of LBO debt, leaving a surplus for the LBO sponsors. Another part of the "financial" story has been the tax advantage of debt: interest payments are tax deductible (and thus shield the portco's profits from tax) whereas dividend payments are not. Here the source of gains is a transfer from the public fisc, not a reduction in private agency costs.

Over time, the "financial" advantages have dwindled. The LBO movement generated corporate governance externalities: In the effort to avoid becoming the target of a financial buyer, managements avoided accumulating excess free cash, often sold or spun off unrelated parts of the business, and avoided making unrelated acquisitions. Put differently, a potential PE target could duplicate the financial-motivated PE buyer's strategy itself. Yet the role of private equity nevertheless expanded; there has been a steady growth in assets-under-management by PE firms and a steady stream of both take-private transactions and "stay private" (with PE-financing) decisions. Importantly, however, there remains a significant limitation on a potential PE target's ability to imitate the PE's strategy: it cannot adopt the PE's governance structure. There are many parts to an account of PE's continued success at attracting capital, but one important element is the PE portco governance model, the way in which development and systemization of a corporate governance model can consistently deliver good returns.

The limitations of Board 2.0 for public companies have produced some alternative approaches. A significant number of technology companies have gone public with dual class common stock, on the contention that the current corporate governance framework with single class common is insufficiently protective of the company's ability to innovate and to pursue a founder's "idiosyncratic vision" that may not be appreciated by the market.[18] Alternatively, one reason management of a public company might favor a take-private transaction sponsored by a PE buyer is that private sale due diligence can fully value a strategy and that PE-style corporate governance can be supportive. Each of these alternative corner solutions has downsides. Dual class common makes ambitious assumptions about the persistence of a founder's unique insight and his/her long-term focus on the business; it also raises public policy concerns.[19] Take-private

17. Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.–Oct. 1989, at 61.

18. *See* Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560 (2016).

19. *See* Lucian A. Bebchuk & Kobi Kastiel, *The Uneasy Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 583 (2017); Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641 (2006); Jeffrey Gordon, *Dual Class Common Stock: An Issue of Public and Private Law*, COLUM. BLUE SKY BLOG (Jan. 2, 2018), http://clsbluesky.law.columbia.edu/2019/01/02/dual-class-common-stock-an-issue-of-public-and-private-law/.

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transactions reduce the set of investment opportunities available to public investors. This unequal access to what might be especially attractive investments raises important public policy concerns as well.[20]

The goal of Board 3.0 is to bring over aspects of the PE portco corporate governance model to public company boards. This will further close the gap between the structural alternatives available to public versus private companies. Apart from firm-specific efficiency gains, expanding the ranging of public company governance options will strengthen the vibrancy of public capital markets in the competition with private markets and expand the set of investment opportunities for the ordinary investor without access to PE limited partnerships.

IV. How a Public Company Adopts and Implements Board 3.0

Board 3.0, on our conception, is a board that contains a mix of directors on the current Board 2.0 model and "empowered" directors ("3.0 directors") who would specifically be charged with monitoring the strategy and operational performance of the management team. The 2.0 directors would serve, as now, on compliance-focused committees and otherwise take on the board's responsibilities, especially serving on "special committees" as necessary. The 3.0 directors would serve on an additional committee, the "Strategy Review Committee." Those directors would be supported by an internal "strategic analysis office" that would provide back-up support for a 3.0 director's engagement with the management team. If additional support was necessary, the 3.0 directors could engage outside consultants. The 3.0 directors would be paid principally through long-term stock-based compensation. The compensation expectations of PE operating or lead directors would be a useful comparator. Because a 3.0 director would be a mid-career professional, additional implicit compensation would come through establishing a reputation for fostering and enhancing value creation at the company. A 3.0 director should be term-limited at a particular company, to minimize the risk of capture and to bolster the role of reputation in enhancing director 3.0 credibility.[21]

For expositional purposes we have focused the Board 3.0 model mostly on its capacity to address information asymmetries between the firm and the public market because the myopia claim has figured so prominently in the debate to date. However, the model and, in particular, 3.0 directors may also be particularly valuable in addressing monitoring shortfalls for complex businesses, for example, JPMC, for which the typical 2.0 director is a poor fit.

Board 3.0 will be costly to implement. The costs include the compensation for the 3.0 directors and the staffing of the Strategic Analysis Office. Additional costs will come from the frictions that could well arise if the 3.0 directors came to

20. *See* Jeffrey Gordon, *Is Corporate Governance a First Order Cause of the Current Malaise?*, 6 J. British Acad. (Supp.) 405 (2018).

21. Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 Stan. L. Rev. 863 (1991) (addressing structural arrangements to enhance the credibility of this type of director).

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question the company's current strategy or management's operational skill (though such costs could be more than offset by potential benefits from changes on either dimension). Thus, Board 3.0 is meant to be optional for firms whose business plans and operational complexity justify its costs. The attraction of the structure thus plainly increases with the opacity or complexity of a public corporation's business and strategy.

How could a company implement Board 3.0? First, the CEO and the management team could propose the opt-in because the 3.0 directors will provide credibility with institutional investors at a time when the company is pursuing a strategy that management believes will be significantly undervalued by public markets—that is, the 3.0 board structure is a response to a belief in market myopia. The CEO's promotion of a Board 3.0 opt-in is a credible signal that the CEO is confident in the strategy and the operational skill of the management team, because the 3.0 director's access to information invites internal questioning and challenges. Second, the impetus for the opt-in could come from the board, specifically the lead director or the nominating-governance committee. The board itself might appreciate that the Board 2.0 model makes it difficult to pursue what the board believes to be the best strategy for the firm, in light of the potential for an activist challenge. Or the board may come to believe it is unable to fully discharge its monitoring responsibilities given the nature of the firm's business.

Third, the opt-in could come in settlement of an activist challenge. Not all activists maintain the within-firm analytic capacity to engage in an ongoing fashion with the strategy and business of an investee company. In general, the shareholder activist targets a firm based on public indicia of apparent underperformance[22] and recruits director candidates (not affiliated with the activist) who are expected to improve the quality of the board. A large fraction of contests settle with the addition of one or more activist candidates to the board.[23] An activist that wants a deeper corporate governance change could press the company to adopt Board 3.0.

One critical question remains: how does the Board 3.0 structure and 3.0 directors gain credibility with institutional investors, the majoritarian voters? Full disclosure, and then observation over time, should make the system self-certifying. The internal resources that support the board's Strategy Review Committee and the 3.0 directors (including appropriate authority as set forth in the charter of the Strategy Review Committee and the company's bylaws); the high-powered compensation for the 3.0 directors; the background and track record of the 3.0 directors—all will be disclosed. The large asset managers have made it clear that the major focus of their corporate governance scrutiny is the quality of the company's directors. They have no interest in reaching out for influence over discrete business questions. But they will be able to evaluate the bona fides of Board 3.0, including the availability of sufficient internal analytic resources, and the background of the 3.0 directors. They will also

22. *See* Shane Goodwin, *Management Practices in an Age of Engaged Investors* (U. Colo. Bus. Sch. Working Paper, Sept. 2017), https://ssrn.com/abstract=3045411.

23. *See* Lazard's 2018 Review of Shareholder Activism 8, 10 (Jan. 2019).

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observe the performance of the firm over time, including the effectiveness of the Board 3.0 structure. One way to think of Board 3.0 from the institutions' perspective is, how long a "leash" does management get when stock market signals are negative? In some cases Board 3.0 would lengthen the leash, but not indefinitely. And for particular firms, the Board 3.0 model, by offering an intermediate solution, may better navigate the risks of market myopia versus management hyperopia than can the Board 2.0 model.

V. Adoption of Board 3.0 with Private Equity as Relational Investor

An alternative route that ports over the PE governance model to the public company is through enlisting the PE firm as a "relational investor." The Board 3.0 model presents certain implementation issues, relating in particular to the creation of an internal Strategic Analysis Office and the selection of 3.0 directors. A PE firm already has an analytic back office and a stable of prospective 3.0 directors. "Relational investing" was promoted in the early 1990s as a way to overcome the purported short-termism of hostile bidders while also limiting managerial agency costs, an earlier form of intermediate solution. The thought was that the growing ownership stakes of institutional investors would give rise to a new governance intermediary, the relational investor, in which institutions would come to see themselves as partners in the creation of long-term value; in short, as "owners."[24] The business model of the typical institutional investor did not, however, lend itself to the genuine engagement that was the hope of relational investing. Most institutions have come to pursue extensive diversification and fee minimization, which is inconsistent with the relational investing model.[25] A handful of contemporary firms are known as relational investors; ValueAct Capital is perhaps the most notable example.

PE firms offer a contemporary route for relational investing. They bring business savvy, a governance model, and a long-enough term focus. One could imagine a model in which a PE firm takes a large enough stake in a public company to give it credible skin in the game along with warrants for an upside, and then gets a special class of redeemable stock that gives it the right to elect directors for a specified period. The redeemable stock gives both the company and the PE firm exit rights at the end of the period; the parties could continue, modify, or end the relationship. In interviews various PE managers have expressed some sympathy with this idea. A stronger version would specify that the redeemable stock would elect a majority of directors, which would give the PE firm stronger monitoring rights over the firm's strategy and managerial performance. This version of Board 3.0 would make a more complete version of PE corporate governance available to the public company. Motivated by the limits of Board 2.0, other techniques will surely evolve, shaped by the characteristics of particular firms and investors.

24. *See, e.g.*, Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 Colum. L. Rev. 124 (1994).

25. *See* Gilson & Gordon, *supra* note 6.

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VI. Board 3.0 as Distinguished from "Board Service Providers"

Our conception of Board 3.0, and Bainbridge and Henderson's proposal to outsource the board via "Board Service Providers,"[26] share a common premise: the current 1970s conception of the monitoring board and its surrounding regulatory structure, however well-meaning and responsive to an earlier set of governance shortcomings, is no longer sufficient to meet twenty-first century governance challenges. As we have suggested earlier, addressing these limitations by giving the board more responsibilities in reaction to a failure to meet the ones they already have may be politically understandable, but it does not work.

The two analyses differ, however, in important ways. We are sympathetic to the movement toward vertical disintegration in industrial organization and governance. Across a wide range of industries, supply chains have displaced vertical integration.[27] The range of expertise necessary for the development of new products is increasingly beyond the capacity of a single firm to manage. The phenomenon has also extended to managerial functions. This is most obvious in the mutual fund industry, where it has become commonplace for large portions of back and middle office operations to be outsourced to expert firms. The explosion in product complexity matched by an explosion in capital market complexity has made it impossible for all but the very largest asset managers to have the scale and, hence, the expertise necessary to fulfill these functions internally.[28]

But governance is different. We fear that outsourcing the board responds to one agency problem by replacing it with another, more complex one. In supply chain management, both contracting parties are commercially sophisticated and often will have co-developed the ultimate product of which the outsourced element will be a part. As the product matures and uncertainty diminishes, the supply contract becomes more explicit, detailing with precision what is to be made.[29] None of this creates agency problems within an entity on either side of a step in the supply chain.

In contrast, we do observe agency problems when public corporation monitoring is outsourced. The role of the outside auditor is the most obvious example and illustrates the problem. The literature recognizes that management selects the auditor, subject to the routine approval by the independent directors and shareholders. But the auditors present their own conflicts of interests. Recall

26. Stephen M. Bainbridge & M. Todd Henderson, Outsourcing the Board: How Board Service Providers Can Improve Corporate Governance (2018).

27. Ronald J. Gilson, Charles Sabel & Robert C. Scott, *Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration*, 109 Colum. L. Rev. 431 (2009).

28. The outsourcing for mutual funds in some cases extends to portfolio management, the funds' central function. In this setting, portfolio management is undertaken by an unrelated sub-advisor entity under contract with the overall advisor to the fund. *See* Joseph Chen, Harrison Hong, Wexi Jiang & Jeffrey D. Kubick, *Outsourcing Mutual Fund Mgmt.*, 67 J. Fin. 523 (2013). In this setting, the mutual fund begins to look more like a platform than a traditional firm. *See* Andrew McAfee & Erik Brynjolfsson, Machine, Platform, Crowd (2017).

29. *See* Ronald J. Gilson, Charles Sabel & Robert C. Scott, *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice and Doctrine*, 110 Colum. L. Rev. 1377 (2010).

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that the Arthur Anderson debacle resulted in no small part because partners' compensation was affected by client revenues. Determination of proper accounting treatment by the firm's national office when the client and the firm disagreed was, unlike other auditing funds, only advisory; the final determination was made by the regional partner whose compensation, like that of the audit partner, depended on keeping the client. A similar tension is presented by the development of accounting firms' consulting practices, which typically generate higher revenue for the auditor from an audit client than does the audit fees. Again, the monitoring function is subject to agency problems within the entity to which it has been outsourced.

This phenomenon is hardly limited to the audit profession. Think about an economic consulting firm that does litigation support work. When an expert who is represented to the court to be independent also holds equity in the economic consulting firm that supports her, there is an obvious conflict. The best clients are large firms (the large law firms and corporate firms that choose the support firm and the expert) that can be anticipated to have future need for experts. Because the expert's ultimate opinion is crafted only after the expert's firm's retention, and because a client who is disappointed by how far the expert will stretch may be less likely to retain the expert or his/her firm, an agency problem arises between the expert and the court, to whom the expert asserts her independence.

Our concern with these governance supply chain agency problems is that they appear to be applicable to the outsourcing of the board. If, as would be expected, the choice of the "board service provider," like the choice of the auditing firm, will be driven by management, and if the compensation of those who act as directors necessarily depends on the outsourcing firm's success, then the circumstances begin to resemble that of the auditors, only worse.

To be sure, there are scale and scope economies available from a higher quality board that has the resources to address difficult problems without having to rely on management. But a change in structure to capture these economies is not a new idea; Gilson and Kraakman argued twenty-five years ago that one could structure a board that was both of high quality and independent of management, by making directors dependent on shareholders to keep jobs designed to be attractive.[30] Board 3.0 captures the idea of improving the skills and experience of independent directors in the same fashion as we observe with the directors of private equity portfolio firms. Board 3.0 directors will have realistic power to develop inside analytic capacity and to retain outside experts where circumstances require it, but without the organizational agency problems embedded in Bainbridge and Henderson's outsourced board proposal. Thus Board 3.0 points

30. Gilson & Kraakman, *supra* note 21. We should note that over the period since the Gilson and Kraakman article appeared, institutional investors have continued to publicly favor higher quality board members. However, they also remain reluctant to get into the activity of selecting or actively influencing the choice of directors.

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the way toward a more talented and engaged board without adding another layer of agency conflicts.

VII. Conclusion

Perhaps the most important takeaway is that the received board model, Board 2.0 (Board 2.1?)—the monitoring board staffed by part-time independent directors—is an organizational experiment, not a dictate inscribed on stone tablets. The pattern of public corporation ownership has changed radically over the course of forty years, as has the scale and complexity of the businesses of such firms. Directors who are thinly informed, under-resourced, and boundedly motivated are not a good complement with today's demands for high-powered governance. Board 3.0 provides a basis for discussion of an optional model for firms that need a governance structure to match the changed circumstances.

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Cleary M&A and Corporate Governance Watch
Mergers and Acquisitions, Corporate Governance, Shareholder Activism

Caremark and Reputational Risk Through #MeToo Glasses

By Arthur H. Kohn, Elizabeth K. Bieber & Vanessa C. Richardson on May 18, 2018

Public and private businesses today face many decisions that do not arise from, and have consequences far beyond, solely financial performance. Rather, these decisions are primarily driven by, and implicate, important social, cultural and political concerns. They include harassment, pay equity and other issues raised by the #MeToo movement; immigration and labor markets; trade policy; sustainability and climate change; the manufacture, distribution and financing of guns and opioids; corporate money in politics; privacy regulation in social media; cybersecurity; advertising, boycotts and free speech; race relations issues raised by the pledge of allegiance controversy; the financing of healthcare; the tension between religious freedom and discrimination laws; and the impact of executive pay on income inequality, among others. If the nature of the issues is not unprecedented, the number, diversity and polarization seem to be.

Delaware courts and shareholders currently assess decisions made by boards of directors primarily under the business judgement rule and the 1996 *Caremark* standard. Many other states have similar schemes for evaluating director decisions or follow Delaware precedent. Generally, *Caremark* addresses the legal standard of culpability when directors are alleged to have failed to address a risk, while the business judgment rule provides a framework for assessing affirmative board decisions unless a more substantive review is warranted.

Companies and boards have traditionally viewed the risk of liability under *Caremark* as being primarily a compliance issue; a well-designed and administered compliance function should bubble up to directors the issues and information that require their attention, satisfying the *Caremark* duty of attention. A long series of Delaware decisions describe a *Caremark*-based derivative challenge as

"possibly the most difficult theory in corporation law on which a plaintiff might hope to win a judgment."

This blog post explores the potential for change in the *Caremark* standard in light of the current intersection of business and social, political and cultural issues.

The Caremark Standard

The *Caremark* decision arose from a failure of Caremark International Inc. to comply with laws concerning inducements to prescribe drugs. The plaintiffs alleged that Caremark's directors breached their duty of care. Chancellor William Allen stated that "evaluation of the central claim made entails consideration of the legal standard governing a board of directors' obligation to supervise or monitor corporate performance". He determined that "where a director in fact exercises a good faith effort to be informed and to exercise appropriate judgment, he or she should be deemed to satisfy fully the duty of attention". Decisions subsequent to *Caremark* have drawn a distinction between, on the one hand, inadequate or flawed efforts by directors and, on the other hand, a conscious disregard for fulfilling fiduciary obligations. "The decision to act and the conscious decision not to act are thus equally subject to review under traditional fiduciary duty principles."**[1]**

Reasons for Revisiting the Caremark Standard in the Current Environment

As stated above, some of the most challenging issues facing business today have substantial components that are not traditional business issues. In a way, Chancellor Allen anticipates today's business challenge for directors by expressly premising his holding on moral considerations: "one wonders ***on what moral basis*** might shareholders attack a good faith business decision of a director as 'unreasonable' or 'irrational'" (emphasis added). That is not to say that the *Caremark* opinion suggests that moral failures should be a basis for director liability. Rather, the *Caremark* opinion suggests that the standard for director liability should in some way reflect the moral issues at stake: asking whether there is a moral basis for the courts to hold directors liable for not ferreting out an obscure compliance failure that results in a modest financial penalty is also by implication asking whether there is a moral basis for the courts to ***not*** hold directors liable for turning a blind eye to issues of great political, social or cultural consequence.

Chancellor Allen's "duty of attention" is an important focus for today's issues because directors may be inclined to think that addressing the fraught political, social and cultural aspects of today's issues is beyond their purview, because they are not primarily business issues. However, precisely for that

reason, the moral basis for judging directors based on how they deal with today's issues may have evolved.

The Caremark Context

In his *Caremark* opinion, Chancellor Allen tightens the standard that was adopted in *Graham v. Allis-Chalmers Mfg. Co.* about thirty years earlier. The *Allis-Chalmers* court held, in a claim against directors arising in the context of anti-trust violations, that there was no basis to find the directors liable for breaching a duty to be informed of the corporation's operations, famously stating that "absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists."

Chancellor Allen found at least a broad reading of the *Allis-Chalmers* standard to be insufficient, stating that "modernly this question has been given special importance by an increasing tendency, especially under federal law, to employ the criminal law to assure corporate compliance with external legal requirements, including environmental, financial, employee and product safety as well as assorted other health and safety regulations."

He held, to the contrary, that a board must assure itself "that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance." Chancellor Allen focused on the obligation of directors to collect the facts necessary to reach informed judgment and concluded that turning a blind eye was not an appropriate alternative.

In the same year that he wrote his *Caremark* opinion, Chancellor Allen also wrote the opinion in *Gagliardi v. TriFoods*, which he cited in *Caremark*. *Gagliardi* provides examples of the kinds of decisions that Chancellor Allen likely had in mind when he decided Caremark: (1) TriFoods' former president causing the corporation to pay $125,000 to a consultant for the design of a new logo and packaging; (2) directors acquiescing in a "reckless" commission structure in order to build sales volume; (3) directors tolerating duplicate product research facilities; (4) directors overpaying in a corporate acquisition; and (5) directors failing to pre-empt harm to customer relations arising from delivery of poor product, and to supplier relations from poor payment practices.

Compare that list to the kinds of potential claims that could arise from the difficult issues of today:

(1) failure to prevent a corporation from employing large numbers of undocumented illegal aliens, one of whom gets into a fatal car accident on the way home from work;

(2) failure to oversee compliance with environmental standards, resulting in unacceptable levels of toxins in the drinking water of a poor urban neighborhood;

(3) failure to terminate the employment of the CEO, a sexual predator;

(4) failure to adopt best practices for background checks in connection with the sale of assault rifles, one of which is used in a school shooting;

(5) failure to appropriately monitor or react to corporate compliance with political contribution rules, or to protect customer data, likely affecting the results of elections; or

(6) failure to ensure an appropriate response to consumer boycott threats arising from advertising support on controversial media outlets.

This is a nightmare list of potential claims, to be sure (albeit only a partial one), but is it clear that the standard applied to director conduct in these situations would, taking into account Chancellor Allen's moral basis test, be consistent with our current understanding of the relatively forgiving *Caremark* standard?

Whose Responsibility?

One line of thought suggests that responsibility for these new and difficult issues lies primarily with management, and not with directors. A few considerations seem particularly relevant to this question.

First, management, and not directors, are usually the driving force for company action. While the board oversees the company and sets strategy, management implements that strategy and generally has broad discretion afforded to it through board delegation under state law. As we have noted, directors may be sued directly for their or company actions, or inactions, but the system provides a relatively broad shield that insulates their decisions from being second-guessed by the judiciary. Management, tasked with the responsibility of running the day-to-day operations, is subject to more uncertain standards.

In 2009 in *Gantler v. Stephens,* Delaware made it clear that corporate officers owe the same fiduciary duties as directors. However, *Gantler* stopped short of reviewing officer conduct under any standard

(and therefore did not apply the business judgment rule) and there have been limited overtures regarding the applicable standard of review for officers' conduct in cases since then.[2] In addition, the court in *Gantler* asserted that the consequences of a breach of fiduciary duties would not necessarily be the same as a director's breach. It remains unclear how an officer's fiduciary duties are to be measured; despite the assertion in *Gantler* that officers owe fiduciary duties, there is no mechanism to enforce or assess the fulfillment of those duties. [3]

Second, senior management is accountable directly to the board, as the board has the power to select and fire those individuals. Directors are accountable to shareholders who have the ability to vote them out as directors. In the past few years, there has been a rapid and significant evolution in investor expectations and attitudes towards the companies in which they invest in regard to stewardship. In addition, demand for socially responsible investing has grown, and traditional institutional investors, as well in some cases as activists, have focused their stewardship advocacy directly on boards (and in the creation of investment vehicles that invest only in companies that meet certain social or environmental criteria). As investor expectations in this regard continue to evolve, investors are increasingly focused on the power of their votes. We have already begun to see a shift in voting behavior evidencing votes serving both a financial and social and political functions. Thus far, however, institutional investors have been vocal about linking their views on social and political issues to the manner in which such decisions affect financial performance, or as a proxy for a board's understanding and management of risk that in turn affects financial performance. Whether significant numbers of investors will place a stronger emphasis in voting decisions on social and political views, such that elections are affected by issues that are not primarily financial issues, is an interesting and open question.

Third, there are typically minimal tangible repercussions under current law for a director who is found to have breached his or her fiduciary duties. Broad indemnification laws and agreements mean that few directors have been personally liable for any portion of a monetary judgment.[4] The specter of reputational harm is real, but does it justify the relatively director-friendly *Caremark* standard? How should additional demands on, or expectations for, directors, if they seem to be appropriate, be balanced with the risk that the most-qualified individuals may refuse to serve because of the corresponding additional risks? A year ago, few directors would have thought that the board's attitude towards ferreting out sexual harassment would be material to their jobs as directors; today many more see that concern. So, in a sense the change in expectations has already occurred without a change in law, but will a change in law follow? Should it?

How Could Change Come About?

While it may not be obvious what set of facts could give rise to a claim arising from today's issues, it is not a stretch to imagine that one would. Director fiduciary claims have already been brought based on allegedly pervasive sexual harassment issues. Are we at the beginning, middle or end of a period of unusual tension concerning today's divisive issues?

Perspectives on the Caremark Standard

As stated above, the *Caremark* standard requires boards to stay informed about matters that could affect "judgments concerning both the corporation's compliance with law and its business performance." What about corporate conduct that implicates today's pressing political, cultural and social issues. For example, should boards be expected to stay informed of issues relating sexual harassment at their companies, or business practices that could implicate important religious freedom issues, even if they do not seem to implicate material financial or legal compliance concerns?

As also stated above, the *Caremark* standard applies to board inaction, whereas the actions of directors are subject to substantive review if not protected by the business judgment rule. The business judgment rule protection requires independence, due care and good faith. In the context of today's highly visible and contentious issues, what justifies the different standards applicable to judicial review of board inaction, on the one hand, and board action, on the other? Should corporate losses arising from these issues be presumed to be the result of a "conscious decision not to act"?

Take-Aways

For as long as *Caremark* continues to be the law, directors should ensure that they at least meet the *Caremark* standard in connection with the #MeToo movement and other issues relevant to their businesses, but they should not be too concerned about new liability risks, even in the current environment. Meeting the *Caremark* standard includes periodically assuring that there is a system for information and problems to come to the board's attention. The application of the *Caremark* standard to today's issues does not require novel efforts.

However, reputational risks for *companies* and *directors*, distinct from liability risks, deserve to be highlighted in the current environment. The enterprise risk approach that many companies and boards take should be re-examined to ensure that they are designed so that reputational risk concerns will bubble up to the board. In our experience this adjustment has already happened at many companies.

Finally, a move away from the *Caremark* standard in judging board conduct seems conceivable, but certainly not inevitable. Any such change would likely be motivated by a different moral calculation than prevailed in the past, one that arises from the social, cultural and political nature and scope of the issues facing business today. It might reflect political calculations related to today's populist trends and a backlash against the corporate class. The change could be ushered in by Delaware courts examining a controversy arising under the current legal framework, or by changes in law, for which there is precedent in Sarbanes-Oxley (arising from the Enron and WorldCom scandals) and Dodd-Frank (following the financial crisis).

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[1] *Louisiana Municipal Police Employees' Retirement System v. Pyott*, 46 A.3d 313 (Del. Ch. 2012).

[2] The U.S. District Court for the District of Delaware in the bankruptcy case *Palmer v. Reali* in September 1996 noted that the of whether the business judgement rule applies to officers deserves further analysis, but restrained itself from opinion as the defendants cited no cases in which a Delaware court held that the business judgment rule applied to corporate officers.

[3] Interestingly, in late 2017, Nevada enshrined the business judgment rule for directors and officers in state law.

[4] The court in *Gantler* also noted that no parallel exculpation for officers exists under Delaware law.

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Cleary M&A and Corporate Governance Watch

Mergers and Acquisitions, Corporate Governance, Shareholder Activism

Not So Sweet: Delaware Supreme Court Revives *Caremark* Claim, Provides Guidance On Directors' Oversight Duties

By James E. Langston, Mark E. McDonald & Philippa Ratzki on June 24, 2019

Last week, the Delaware Supreme Court reversed the Delaware Court of Chancery's dismissal of a *Caremark* claim[1] that arose out of the Blue Bell ice cream listeria outbreak in the mid-2010s. *See* ***Marchand v. Barnhill***, No. 533, 2018 (Del. June 18, 2019). The Delaware Supreme Court's opinion in this closely watched case provides useful guidance to directors on the proper role of the board in overseeing risk management.

The allegations in *Marchand* were stark. The listeria outbreak resulted in the death of three Blue Bell customers, the complete recall of its ice cream products, months-long closure of its manufacturing facilities and a highly dilutive rescue financing that was required to keep the company afloat. To make matters worse, leading up to the outbreak, it was alleged that numerous deficiencies in the company's food safety controls of increasing severity were uncovered, yet there was no record the problems were ever discussed by the board. Instead, board minutes indicated the board was briefed on positive food safety developments during this period and that the board did not turn its attention to the listeria situation until after a product recall had been issued.

Based on the facts alleged, the Delaware Supreme Court concluded that it was reasonably conceivable the Blue Bell board had breached its *Caremark* duties by failing to take any steps to establish a board-level system to monitor a key risk facing the company — the safety of its ice cream products. Although the directors pointed to management's efforts to comply with FDA and state food safety regulations and general updates to the board on the company's operations, the Court noted that the board could not simply rely on management's compliance efforts or discretionary reporting on

operational matters. Rather, to discharge its *Caremark* duties the board had to undertake a good faith effort to establish a risk oversight system at the board level to address key risks facing the company and then monitor such system.**[2]**

We do not believe *Marchand* signals a radical change in how Delaware courts will evaluate *Caremark* claims — among other reasons, the complaint alleged unusual, troubling facts and the court was required to draw all reasonable inferences in favor of the plaintiffs in the context of the motion to dismiss the complaint. However, the case is a reminder that *Caremark* claims are not impossible to establish and in the event of particularly egregious facts can be used to hold directors accountable. *Marchand* also includes important reminders for boards in performing their risk oversight role, including:

- Ensure board-level protocols are in place that require management to regularly report on key risks, steps taken to manage those risks and any significant compliance deficiencies.
- The board should also regularly consider the company's risk management efforts and adequacy of the board-level protocols — the Court suggested quarterly or biannually — and not wait for the crisis to arrive for the discussion to begin.
- Ensure the board-level protocols are documented and that the board discussion of risk management is contemporaneously and accurately documented in the board minutes.**[3]**
- *Caremark* is not a strait jacket and the Court was careful to note that boards have flexibility to design a risk oversight system that is tailored to the company's business and resources (and, as long as the board makes a good faith effort to implement such a system and then monitor it, the courts will defer to the board's business judgment as to how it is designed).

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[1] *See In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996) (Allen, C.). Directors' "*Caremark* duties" require them to make a "good faith effort to oversee the company's operations." *Marchand*, slip op. at 29 (citing *Caremark*, 698 A.2d at 970, and *Stone v. Ritter*, 911 A.2d 362, 372 (Del. 2006)). Such effort requires an "information and reporting system [that] is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner." *Id.* Directors will only face personal liability under *Caremark*, however, where there is a complete failure to implement such a system or a conscious failure to monitor it, evidencing bad faith.

[2] In the same decision, the Court also held that it was reasonably conceivable based on the pled facts that a majority of the directors were not independent of, and thus incapable of impartially deciding whether to sue, the CEO and VP of Operations of the company. Emphasizing that "Delaware law should not be based on a reductionist view of human nature" incapable of accounting for the real-life "social nature of humans," *Marchand*, slip op. at 25 n.87, the Court explained that there was reason to doubt that the director whose independence was disputed would be capable of impartially deciding whether to sue the Blue Bell CEO based on the director's "long-standing, close relationship" with the CEO and family previously controlling Blue Bell that included giving the director his start at Blue Bell as a low-level employee, mentoring the director as he climbed the Blue Bell corporate ladder all the way up to CFO and spearheading a charitable contribution to a local college in the director's honor.

[3] As is increasingly common in stockholder lawsuits, the plaintiff in this case first obtained minutes and other documents from the company pursuant to a Section 220 inspection demand, and then used those documents to craft a detailed complaint. Because this is an increasing trend, it is all the more important for board minutes and other formal board records to adequately document the board's deliberations.

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