

COMPLY-AND-EXPLAIN: SHOULD DIRECTORS HAVE A DUTY TO INFORM?

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“Can we end the long tradition of the boardroom as a sealed chamber from which we issue only unanimous endorsements of management’s actions and results? Can we move toward more transparency about the boardroom process, without undermining the ability of management teams to produce the results that shareholders want?”¹

I

INTRODUCTION

A new “Directors’ Duty to Inform” could be derived from the “Standards of Conduct for Directors” in section 8.30 of the Model Business Corporation Act (MBCA).² To fulfill their duty to inform, directors of publicly held companies would be obligated to explain to shareholders how they are discharging their duties in a manner they “reasonably believe to be in the best interests of the corporation.”³

A duty to inform would have five main objectives:

1. Explain the relationship between the board’s governance decisions and the company’s business goals;
2. Enable shareholders to make an informed evaluation of
 - A. the company’s governance,
 - B. the directors’ competence and independence, and
 - C. the board’s exercise of business judgment;
3. Enhance directors’ credibility through the articulation of

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1. Leon Panetta, *It’s Not Just What You Do, It’s the Way You Do It*, DIRECTORS & BOARDS, Winter 2003, at 17, 21. For a general discussion of the problems of board–shareholder communication at U.S. companies, see generally Symposium, *Who Speaks for the Board?*, DIRECTORS & BOARDS, Second Quarter 2010, at 18; COMM. ON CORPORATE LAWS OF THE ABA SECTION OF BUS. LAW, REPORT ON THE ROLES OF BOARDS OF DIRECTORS AND SHAREHOLDERS OF PUBLICLY OWNED CORPORATIONS, available at http://www.abanet.org/media/nosearch/task_force_report.pdf; see also Stefan Stern, *Investors Want You to Tell a Better Story*, FINANCIAL TIMES.COM (May 31, 2010), <http://www.ft.com/cms/s/0/c3bcd18e-6cdb-11df-91c8-00144feab49a.html>.

2. MODEL BUS. CORP. ACT § 8.30 (2008).

3. See *id.* § 8.30(c) (This section obliges directors to act in accordance with their reasonable beliefs about the best interests of the corporation, but it does not require that they communicate these beliefs to the shareholders).

- A. the processes by which board decisions are made, and
 - B. the strategic rationale for their decisions;
4. Encourage customization, flexibility, and strategic focus in boards' corporate governance practices comparable to the "comply or explain" approach used in principles-based governance systems; and
 5. Promote dialogue and reduce confrontation between boards and shareholders.

The substantive information provided by directors pursuant to a duty to inform would be company-specific, qualitative, contextual, and forward-looking, thereby bringing it within the protection of the business judgment rule. The intent of the duty would not be to increase directors' liability, but to increase their accountability to shareholders.⁴

The duty could be discharged by means of a written annual "Directors' Discussion and Analysis" or by periodic communications from board committees or the board chair to the shareholders.

The expected long-term impact of a duty to inform would be to "operationalize" corporate governance policies and accustom boards to provide greater transparency about their deliberations and decisions on matters relating to governance, business oversight, and strategy.

Regardless of whether a directors' duty to inform can be inferred from the MBCA or other provisions of state law, it could be implemented through the adoption of a charter or bylaw amendment initiated by the board or by shareholders.

II

THE PROBLEM: SHAREHOLDERS NEED TO OBSERVE AND UNDERSTAND BOARD CONDUCT

Nell Minow, editor and co-founder of The Corporate Library, has famously said: "[B]oards [of directors] are like subatomic particles—they behave differently when they are being observed"⁵

The key words in Minow's statement are "observed" and "behave." From the perspective of long-term investors, corporate governance is primarily a means to observe and monitor the behavior of directors, who are the shareholders' elected representatives, and to influence their behavior when necessary. The simple presumption behind most governance reforms is that directors will act with greater care and diligence when they are effectively monitored and accountable for their decisions. This presumption is a matter of human nature rather than law.

4. The liability for selective disclosure prohibited by Regulation FD under the Securities Exchange Act could be avoided by limiting the topics covered by a duty to inform. See the discussion in COMM. ON CORPORATE LAWS, *supra* note 1, at 11 n. 24.

5. *The Prime of Ms. Nell Minow (A CFO Interview)*, CFO MAGAZINE, Mar. 2003, at 56, 62.

Given the goal of improved observation, a major governance dilemma arises because the boards of U.S. companies conduct their deliberations and make their decisions behind closed doors. Even though two decades of governance reforms have expanded companies' disclosure requirements and amplified the duties and responsibilities of directors, boardroom windows at U.S. companies remain closed, with shades down and curtains drawn.

Corporate advocates in the United States vigorously defend boardroom privacy on grounds of collegiality, competitiveness, independence, and respect for directors' expertise and business judgment. However, boardroom secrecy and constraints on communication create problems: they can polarize relations between directors and shareholders, forestall dialogue, undermine trust, reinforce adversarial forms of engagement, and impose substantial costs on both companies and shareholders. For companies, the primary costs of board secrecy involve the time and resources boards must devote to formal compliance with governance rules, disclosure requirements, and shareholder engagements—not to mention the legal, lobbying, and public-relations dimensions of these activities. Shareholders, particularly institutional investors, incur comparable costs in their governance advocacy, monitoring of portfolio companies, engagement campaigns, activism, and promotion of shareholder rights—not to mention the losses incurred when poor governance practices cause the value of portfolio companies to decline.

In addition to imposing these systemic costs, board secrecy and adversarial relations between companies and shareholders have contributed to the rise of a proliferating industry of corporate-governance experts, proxy-advisory firms, governance-rating entities, proxy solicitors, consultants, and intermediary service providers. The demand for the services of these firms has grown rapidly during the past two decades in parallel with increases in governance regulation and shareholder activism. At this point, there is every reason to think that the costs and resource demands associated with these activities will continue to grow in the aftermath of the financial crisis and the new Dodd-Frank regulatory regime.⁶

Even though shareholders have achieved a largely unbroken record of success in promoting governance reforms, it is becoming increasingly clear that there is a limit to the effectiveness of prescriptive rules and external metrics. The financial crisis demonstrated all too clearly that compliance with rules and best practices does not ensure good governance. In some high-profile cases, companies' full compliance with governance norms did little more than provide cover for weak board oversight, incompetence, and fraud.

In this skeptical post-crisis environment, new strategies are needed to ensure that boards are not just compliant, but are implementing governance effectively. These strategies must come from within the boardroom. Although

6. *See generally* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

shareholders will continue to demand greater transparency and accountability, a window into the boardroom can be opened only by the directors. Boards must act on their own initiative, not just in response to more disclosure requirements and governance rules.

III

POTENTIAL SOURCES OF THE DUTY TO INFORM

A. The Model Business Corporation Act

The MBCA is a logical place to focus the search for the fundamentals of a directors' duty to inform. Section 8.30 of the MBCA sets forth the "Standards of Conduct for Directors."⁷ The operative language in section 8.30(a) states: "Each member of the board of directors, when discharging the duties of a director, shall act: (1) in good faith, and (2) *in a manner the director reasonably believes to be in the best interests of the corporation.*"⁸

The comment to section 8.30(a) explains: "The phrase 'best interests of the corporation' is key to an explication of a director's duties. The term 'corporation' is a surrogate for the business enterprise as well as a *frame of reference encompassing the shareholder body.*"⁹

In essence, the MBCA confirms the common understanding that directors have a duty to act in the best interests of the company and its shareholders. From both corporate and shareholder perspectives, the purpose of corporate governance should be to support this principle that aligns the interests of shareholders with the economic success of the business enterprise.

The generic MBCA Standards of Conduct for Directors are supplemented by the language in section 8.30(c), which requires a director to "disclose . . . to the other board or committee members information not already known by them but known by the director to be material to the discharge of their decision-making or oversight functions."¹⁰ The comment describes this standard as "a duty of disclosure among directors."¹¹

Although section 8.30(c) defines a limited reciprocal duty among board members, it could be recast to serve as a template for a directors' duty to inform. Substitution of the word "shareholders" for the words "other board members" in section 8.30(c) would transform and broaden the duty to "encompass the shareholder body." With this textual revision, the new version of section 8.30(c) would read as follows: "In discharging board or committee duties a director shall disclose, or cause to be disclosed, to the *shareholders* information not already known by them but known by the director to be

7. MODEL BUS. CORP. ACT § 8.30 (2008).

8. *Id.* § 8.30(a) (emphasis added).

9. *Id.* § 8.30 cmt. 1 (emphasis added).

10. *Id.* § 8.30(c).

11. *Id.* § 8.30 cmt. 3.

material to the discharge of their decision-making or oversight functions” Under the revised language, the phrases “not already known by them” and “their decision-making or oversight functions” would refer to the shareholders rather than the directors. If Nell Minow’s observation is correct, this simple change of wording would effect a radical transformation in boardroom behavior by exposing directors’ decision-making to closer observation by shareholders.

Corporate directors have not traditionally been responsible for determining what information is material to their shareholders’ “decision-making or oversight functions.” Disclosure requirements under federal and state law have led companies to focus on materiality with respect to shareholders’ investment decisions, not their administrative functions. Nevertheless, from the perspective of corporate governance, there are compelling reasons for expanding the board’s standards of conduct under section 8.30 to address the duties and responsibilities of shareholders that are analogous to those of corporate directors.

Like corporate directors, many institutional investors, financial intermediaries, and other trustees are fiduciaries. Under the Employee Retirement Income Security Act of 1974, the Department of Labor has long regarded the exercise of proxy votes as a fiduciary duty of pension trustees and their designated investment managers.¹² As fiduciaries acting on behalf of beneficial owners, the “decision-making and oversight functions” of investors include voting proxies and electing the directors of portfolio companies. A persuasive argument can be made that in order to discharge their fiduciary duty to vote shares and elect directors in an informed manner, investors should have access to “material . . . information not already known to them” about the conduct of portfolio companies’ directors and their discharge of the duties set forth in section 8.30.¹³ A directors’ duty to inform would provide this information to shareholders.

B. The Corporate Director’s Guidebook

The *Corporate Director’s Guidebook*, developed by the American Bar Association Committee on Corporate Laws, is another logical source for understanding and interpreting board duties.¹⁴ Section 3 of the *Corporate Director’s Guidebook* sets forth the “Responsibilities, Rights and Duties of a

12. Letter from Alan D. Lebowitz, Deputy Assistant Sec’y, Dep’t of Labor, to Helmut Fandl, Chairman of the Ret. Bd. of Avon Prods., Inc. (Feb. 23, 1988), *reprinted in* COUNCIL OF INSTITUTIONAL INVESTORS, EVERYTHING YOU ALWAYS WANTED TO KNOW ABOUT PROXY VOTING BUT WERE AFRAID TO ASK 14–16 (2007), *available at* <http://www.cii.org/UserFiles/file/resource%20center/publications/Proxy%20Voting%20Primer.pdf>; *see also* Interpretive Bulletins Relating to the Employment Retirement Income Security Act of 1974, 29 C.F.R. § 2509.94-2 (1994); Interpretive Bulletin Relating to the Exercise of Shareholder Rights and Written Statements of Investment Policy, Including Proxy Voting Policies or Guidelines, 29 C.F.R. § 2509.08-2 (2008).

13. MODEL BUS. CORP. ACT § 8.30 (2008).

14. COMM. ON CORPORATE LAWS OF THE ABA SECTION OF BUS. LAW, CORPORATE DIRECTOR’S GUIDEBOOK (5th ed. 2007).

Corporate Director.” Section 3.C.4 describes as one of the “legal obligations” of a corporate director a “duty of disclosure” that comes close to the concept of a duty to inform, but falls short in several ways.¹⁵

Section 3.C.4 states: “As fiduciaries, directors have an obligation to take reasonable steps to ensure that shareholders are furnished with all relevant material information known to the directors *when they present shareholders with a voting or investment decision.*”¹⁶ The emphasized language limits the duty by aligning it with disclosure requirements that exist under federal securities laws and narrowing the context to situations that involve specific action by shareholders. It does not establish a general continuing duty to inform shareholders about board processes and conduct.

Section 3.C.4 also mentions that some courts have expanded the board’s duty of disclosure beyond circumstances involving shareholder action: “[E]ven where the directors are not recommending shareholder action, they have a duty (independent of disclosure obligations generally under the federal securities laws) not to mislead or misinform shareholders.”¹⁷ This interpretation is helpful in its acknowledgement that the state law duty of disclosure is independent and separate from federal disclosure requirements. However, it describes the duty in negative terms as an obligation “not to mislead or misinform shareholders,” rather than asserting an affirmative duty to provide shareholders with information that is material to their evaluation of directors’ conduct and business judgment.

Directors’ “disclosure” and “transparency” duties should be distinguished from the duty to inform in order to reinforce the qualitative differences in information communicated by a board at will rather than pursuant to a legal mandate. The duty to inform should not set limits, or dictate information that is deemed to be material, or mandate specific disclosures. Instead, the duty should encourage open communication in the form of a narrative that tells the story of a board’s decision-making processes and the strategic rationale for its choices in the context of the individual business enterprise. The substance of the narrative should be based on the judgment of the directors, not dictated by compliance requirements.

C. The U.K. Governance System: Comply-or-Explain

By definition, a duty to inform would confer broad discretion on directors to explain how they discharge their duties in a manner they “reasonably believe to be in the best interests of the corporation.” The duty would introduce a do-it-yourself dimension to boards’ corporate governance programs that would be largely voluntary and self-administered. The duty would not be administered by a regulator (as the Securities and Exchange Commission (SEC) regulates

15. *See id.* at 26.

16. *Id.* (emphasis added).

17. *Id.*

shareholder proposals under Rule 14a-8).¹⁸ It would not be enforced by a self-regulatory organization (SRO) (as the New York Stock Exchange enforces listed company standards with the threat of delisting).¹⁹ It would generally involve decisions protected by the business judgment rule and would therefore not be subject to the “Standards of Liability” defined in section 8.31 of the MBCA (although it would certainly be subject to federal and state antifraud provisions). In lieu of these traditional methods of oversight and enforcement, the duty to inform would be based on directors’ accountability to shareholders.

The best-known model for accountability-based governance is the comply-or-explain program that has been in operation in the United Kingdom for nearly two decades.²⁰ Although not without its critics, the United Kingdom’s voluntary comply-or-explain governance regime offers a number of advantages for companies. Comply-or-explain is specifically designed to promote flexible and customized governance practices rather than prescriptive rules and check-the-box compliance. It gives deference to the knowledge, expertise, and judgment of corporate directors. It assumes that boards are best positioned to determine what specific information is relevant to an explanation of non-compliance. It assumes that directors will be candid and avoid boilerplate. Most importantly (and perhaps aspirationally), it assumes that institutional investors will be diligent in committing time and resources to evaluate the quality of a company’s governance decisions in the context of business strategy and financial performance.

The U.K. Corporate Governance Code does not explicitly define a directors’ duty to inform, but it mandates an open relationship and constructive dialogue between directors and shareholders. Section E of the U.K. Code states the following “Main Principle”: “There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place.”²¹ The important principle at the heart of the U.K. Code is that the board itself must assume responsibility for dialogue with shareholders, rather than vice versa. This approach is in contrast with U.S. practice, which discourages communication from boards to shareholders and encourages shareholders to initiate dialogue, usually through adversarial forms of engagement.²²

18. Shareholder Proposals, 17 C.F.R. § 240.14a-8 (2010).

19. N.Y. STOCK EXCH., LISTED COMPANY MANUAL § 802.1D (2009), available at <http://nysemanual.nyse.com/LCM/>.

20. See FIN. REPORTING COUNCIL, THE U.K. CORPORATE GOVERNANCE CODE (2010), available at www.frc.org.uk/documents/pagemanager/Corporate_Governance/UK%20Corp%20Gov%20Code%20June%202010.pdf [hereinafter U.K. CODE]; see also James Hamilton, *UK Reaffirms Comply or Explain Model for Corporate Governance as Financial Crisis Roils*, CCH FINANCIAL REFORM NEWS CENTER (Aug. 28, 2009), <http://financialreform.wolterskluwerlb.com/2009/08/uk-reaffirms-comply-or-explain-model-for-corporate-governance-as-financial-crisis-roils.html> (“The comply or explain approach has been in operation since the Code’s beginnings in 1992 . . . and the flexibility it offers is valued by company boards and by investors in pursuing better corporate governance.”).

21. U.K. CODE, *supra* note 20, § E.1, at 25.

22. See Symposium, *Who Speaks for the Board?*, *supra* note 1.

The U.K. Code's provision E.1.2 further requires: "The board should state in the annual report the steps they have taken to ensure that the members of the board, and, in particular, the non-executive directors, develop an understanding of the views of major shareholders about the company . . ." ²³ Again, the point is that with U.K. companies, the board has a direct role in outreach and dialogue with major shareholders in order to understand their views.

IV

COMPLY-AND-EXPLAIN: A HYBRID GOVERNANCE PROPOSAL

A directors' duty to inform modeled on the United Kingdom's principles-based, comply-or-explain system would pose challenges for U.S. companies. It is unclear whether state law could accommodate a board duty defined with such broad discretion and enforced primarily by means of shareholder accountability. Such a duty would occupy uncharted middle ground between the Standards of Conduct for Directors under section 8.30 of the MBCA and the Standards of Liability under section 8.31 of the MBCA. It is equally unclear whether the U.S. rules-based system of corporate governance could tolerate a principles-based, discretionary approach to directors' duties and standards of conduct.

The success of a hybrid *comply-and-explain* governance system—grafting a new duty to inform onto the existing state and federal regulatory structure—would depend on two developments that are highly uncertain: (1) directors of U.S. companies would have to overcome their habitual antipathy to shareholders, assume a less-defensive posture, and accept primary responsibility for dealing with shareholder concerns related to governance and board conduct; and (2) institutional investors would have to give priority to their responsibilities as long-term owners, commit resources to the oversight of portfolio companies, and reduce their dependence on standardized third party governance analyses and proxy-voting recommendations.

In addition to these legal, structural, and cultural problems, the directors' duty to inform would be likely to encounter resistance from U.S. companies and directors already overwhelmed by compliance requirements and facing additional controversial governance pressures including: the majority-vote standard in director elections, shareholder access, say-on-pay, risk oversight, takeover threats, conflicts of interest, short-termism, empty voting, proxy mechanics, environmental and social policies, and financial-system reform.

Ironically, the imposition of a directors' duty to inform could actually help companies anticipate and avoid many of these contentious issues. A board-level narrative describing the decision-making process and explaining the context and business rationale for board decisions would help defuse shareholder concerns,

23. U.K. CODE, *supra* note 20, § E.1.2, at 25.

reduce confrontation, and ultimately strengthen shareholder support even when there is a perception of non-compliance.

Executive compensation is a useful example that reveals the limits of disclosure rules and the need for better communication about board processes and policies. The say-on-pay movement grew out of shareholder frustration not only with perceived compensation excesses, but also with standardized disclosures that failed to address important strategic questions.²⁴ The goal of an advisory vote is not to micromanage compensation but to increase board accountability and thereby compel directors to align pay with performance and explain how their compensation policies support business strategy and value creation. Through the exercise of a duty to inform, directors would have greater discretion to provide a comprehensive Board Compensation Committee Report explaining their compensation philosophy, their decisions with respect to bonus and variable pay, and the economic goals that the incentives are designed to achieve.

This approach would be more effective than attempting to shoehorn the board's views into the disclosure matrix of the management Compensation Disclosure and Analysis, or waiting to be targeted by shareholders and producing an explanation of directors' policies and decisions after-the-fact.

V

TOWARDS RECIPROCITY: AN INVESTORS' DUTY TO INFORM?

Imposition of a directors' duty to inform would not by itself result in "a dialogue with shareholders based on the mutual understanding of objectives."²⁵ Opening boardroom windows would help, but for interests to be fully aligned, institutional investors must also agree to comparable standards of candor and openness. Constructive dialogue between boards and shareholders must be a two-way street.

Debate over the Dodd-Frank bill launched a discussion of investor responsibility and fiduciary duty in the context of the abuses, conflicts of interest, and governance failures within the financial community that led to the crisis. As financial-system reform unfolds in the United States under the new law, many experts believe that institutional investors will replace companies and directors at the center of the governance-reform spotlight.²⁶ Indeed, on October 21, 2010, the United States Department of Labor announced a proposed rule

24. See, e.g., TIAA-CREF, 10 QUESTIONS FOR EVALUATING CD&A'S (July 2007), available at http://www.shareholderforum.com/op/Library/20070822_TIAA-CREF.pdf.

25. U.K. CODE, *supra* note 20, § E.1, at 25.

26. For further discussion on the evolving role of investors, see generally the recent publications of BOGLE FIN. MKTS. RESEARCH CTR., www.vanguard.com/bogle_site/bogle_home.html; see also John C. Bogle, Founder & Former Chairman, Vanguard Grp., Building a Fiduciary Society Remarks at the IA Compliance Summit (Mar. 13, 2009), available at http://www.vanguard.com/bogle_site/sp20090313.html.

that would substantially strengthen the Employee Retirement Income Security Act (ERISA) definition of a “fiduciary.”²⁷ More reforms are sure to follow.

Discussion of investor responsibility is already well under way in the United Kingdom, where the Financial Reporting Council adopted a Stewardship Code for institutional investors in July 2010.²⁸ It was preceded by an earlier Code on the Responsibilities of Institutional Investors, drafted in November 2009 by the Institutional Shareholders Committee, a forum representing major U.K. institutional investors.²⁹

These efforts may prove useful as a precedent for a U.S. private-sector initiative bringing together both corporate and investor representatives to deal with the conjoined issues of board and investor conduct.

VI

CONCLUSION

Well before the financial crisis, Leon Panetta suggested that companies should open the “sealed chamber” of the boardroom and provide greater transparency about board processes. Instead, boardroom windows remained closed and U.S. governance continued to pursue its traditional course of confrontation, legislation, and rule-making.³⁰ Now, as companies stagger under the burden of compliance and face additional governance challenges in the Dodd-Frank Act, directors should seriously consider whether their sealed chamber is a privilege or a constraint and whether its growing costs outweigh its diminishing benefits.

The recent turmoil in the economy and financial markets underscores the importance of corporate governance and directors’ accountability to shareholders. However, in the United States, there is currently no basis for establishing a directors’ duty to inform shareholders about boardroom deliberations and governance decisions.

Section 8.30 of the MBCA requires directors to act in the best interest of the company and establishes a duty to inform other board members of information material to their decision-making function, yet it stops short of applying that standard to shareholders and investors. *The Corporate Director’s Guidebook* limits directors’ affirmative duty to inform shareholders in situations involving specific actions. The U.K. Code presents a more open model of communication under the voluntary comply-or-explain system, fostering flexibility and deference to business judgment. However, by requiring explanation primarily

27. Definition of the Term “Fiduciary”, 75 Fed. Reg. 65,263 (proposed Oct. 21, 2010) (to be codified at 29 C.F.R. pt. 2510).

28. FIN. REPORTING COUNCIL, THE U.K. STEWARDSHIP CODE (2010), available at [www.frc.org.uk/images/uploaded/documents/UK Stewardship Code July 20103.pdf](http://www.frc.org.uk/images/uploaded/documents/UK%20Stewardship%20Code%20July%2020103.pdf).

29. INSTITUTIONAL S'HOLDERS COMM., CODE ON THE RESPONSIBILITIES OF INSTITUTIONAL INVESTORS (2009), available at <http://institutionalshareholderscommittee.org.uk/sitebuildercontent/sitebuilderfiles/ISCCode161109.pdf>.

30. Panetta, *supra* note 1, at 21.

when the board chooses not to comply, the U.K. Code still presents a level of communication short of the ideal.

A new duty to inform based on the principles of comply-*and*-explain would encourage directors of U.S. companies to articulate how decisions made in the boardroom advance strategic goals and align with shareholder interests. It would preserve directors' discretion in the exercise of business judgment while providing shareholders with greater understanding of board conduct. In Panetta's words, a directors' duty to inform would "move toward more transparency about the boardroom process without undermining the ability of management teams to produce the results that shareholders want."³¹

Under a comply-and-explain system, directors would have to overcome the inertia of a traditionally opaque and defensive posture, while investors would be under an obligation to embrace their oversight function and use their voice and votes to hold directors accountable. If directors and shareholders would both commit to such reciprocal duties, improvements in transparency, accountability, and corporate stability would surely result.

31. *Id.*