

SOME HIGHLIGHTS ON THE ALI PRINCIPLES OF THE LAW: CORPORATE GOVERNANCE & COMPLIANCE, etc.

In the famous Marvin Gaye song from 50 years ago, his lyrics simply ask the poignant question of "who really cares" regarding the world problems back then. Fast forward to today, and his lyrics still resonate in many ways. In the corporate world, who should care has been asked over this time period as well. So what are the legal and business standards of conduct? Fiduciary standards of conduct are the core requirements of corporate governance for directors and officers. They are simply referred to as "fiduciary duties" and there are two (2) principle categories; viz., the duty of care and the duty of loyalty. To introduce these issues, I will address the fiduciary duty of care, and the key legal standard of review as espoused in the ALI's Principles of Corporate Governance (i.e., not state statutory or case law). (The ALI is a leading independent organization in the U.S. producing scholarly work to modernize the law.)

Today, a good start to see how a company should address the duty of care is the *ALI's Principles of Corporate Governance* §4.01(a). The Duty of Care of Directors and Officers; The Business Judgment Rule. It states, in pertinent part, that a corporate director or officer is required to perform their duties "in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinary prudent person would reasonably be expected to exercise in a like position and under similar circumstances."

So how have the courts looked at corporate directors and officers' behavior? The standard of review courts use to protect directors and officers from liability from a violation of the duty of care is the business judgment rule, also found in this section. More specifically, the *ALI's Principles of Corporate Governance* §401(k)(c) states the rule, generally speaking, as follows:

"A director or officer who makes a **business judgment in good faith** fulfills the duty under this section if the director or officer:

- (1) is not interested in the subject of the business judgment;
- (2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and
- (3) rationally believes that the business judgment is in the best interests of the corporation."

In the Comment to this section, on the relationship between the duty of care and the business judgment rule, §401(d) it states, in pertinent part, that "in order to protect directors and officers from the risks inherent in hindsight reviews of their unsuccessful decisions, and to avoid the risk of stifling innovation and venturesome business activities, (this section regarding the business judgment rule) particularizes how the duty

of care concept, as expressed in statutes, cases . . .” should be applied. It goes on further to state that (this section on the business judgment rule) is a “judicial gloss” on the duty of care standards that sharply reduces exposure to liability. In later comments, the ALI refers to the business judgment rule as akin to a “presumption” but unlike same, it is not irrefutable. It also states that this standard of review is not one of whether the directors or officers’ decisions were “reasonable,” but whether they were “rational.” The latter rationality test provides a broader range of discretion than a “reasonably believes” test.

Given the above, how does the “good faith” element in this standard of review play out with regard to key corporate activities. The ALI states, in Comment (b) to §401(c) that the test varies depending on the type of transactions that corporations are engaged in. The five (5) corporate activities mentioned are:

- knowing violations of the law type cases,
- duty of loyalty type cases,
- hostile take over attempts,
- transactions in control, and
- settlement or termination of shareholder derivative actions.

So when reviewing the various activities of a corporation, one needs to address the standard of fiduciary conduct, and the standard of review of good faith as applied to each corporate activity, to see whether their corporate governance complies with the fiduciary duty of care.

More recently, the American Law Institute (“ALI”) Council approved the initiation of the project known as the Principles of the Law: Compliance, Risk Management, and Enforcement (in 2015). According to the Foreword in the 2019 edition, “[t]hese topics have emerged as fundamental components of internal controls in complex organizations, both in the U.S. and around the world.” The purpose of the ALI’s endeavor is to provide best practices for a corporation regarding how to operate their company. There are five (5) chapters outlined. For the purposes of this overview, we will discuss parts of four chapters, namely Chapters 1, 2, 3, and 5. Chapter 1 is basically Definitions. Chapter 2 addresses the overall scope of the project. Chapter 3 deals with the governance of compliance, and lastly, Chapter 5 addresses compliance performance. (*References herein are to the 2019 Tentative Draft of the ALI Council.*) Some highlights are as follows:

- Chapter 1: Definitions: identifies key definitions that should be mentioned here for future reference purposes. Some key definitions for this Article are:

(i) “Duty of Care: The duty to act on an informed and prudent basis with respect to the affairs of an organization.”

(ii) “Duty of Loyalty: The duty not to act in ones’ own interest, or in the interest of another, to the detriment of the best interests of an organization.”

(iii) “Governance Map: A specification assigning responsibility for internal control to persons within an organization.”

Chapter 2: Subject Matter, Objectives, and Interpretation; In Section 2.01 it states that these Principles set forth recommendations of best practices for internal control within organizations, and external control by regulators, prosecutors, and judges. In the comment section, it states that they are a set of standards or recommendations that can provide useful guidance. As such, they may also “appropriately be evaluated in light of practices and norms applicable elsewhere in the world. The small size of an organization . . . is not an excuse for avoiding compliance obligations, but rather a reason for fulfilling these obligations through different strategies, policies, and procedures. As stated in the Manual for the Federal Sentencing Guidelines, smaller organizations may meet the requirements of this guideline with less formality and fewer resources than would be expected of larger organizations.”

Chapter 3: Governance: states in Section 3.01, that governance is defined as “essential to achieving effective compliance and risk management in an organization.” In the Reporters Notes for this chapter, they state that, “governance has to do with the structure of control within an organization.”

Section 3.03 states that, to achieve the governance goals above, “[i]t is best practice for an organization to establish a governance map for compliance and risk management purposes. The purpose of same is to “identify” its major risk issues and “assign” responsibility for same to an organization’s actions.”

Section 3.08 states that the role of the board of directors is to provide the oversight for compliance, risk management, and internal audit. The section goes on to list eleven (11) oversight responsibilities for the board of directors to engage in. The board of directors role’s to ensure that internal control programs and plans are put into place. So they are not required to “design” same, but they must review and approve them. In the Reporters Notes for this section, it reviews the Caremark case and its progeny to state that a director’s duty is to attempt, in good faith, to assure that the information and reporting systems exist and are adequate. So how can directors “direct” all this work?

In Section 3.09, the ALI sets forth the structure to handle oversight responsibilities by the board of directors. Basically, it recommends delegating the duties to a committee (formal), or group of its members (informal). Said committee or group has some key components, viz.:

- (i) The board of directors retains the ultimate authority,
- (ii) the committee members must have the expertise and experience in compliance and risk management to fulfill their responsibilities,
- (iii) the committees must have the necessary resources (and perhaps a charter), that is specific to its role, and

(iv) the committees must regularly report to the board of directors on their work.

In the comments to this section, it addresses both the ABA's Corporate Director's Guidebook, as well as the Caremark case criteria, that the "board exercise a good faith judgment that the corporation's information and reporting system is, in concept and design, adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility."

So we now see the confluence between the concerns of some legal writers being addressed regarding the criteria for the "good faith" test, the Caremark case law, the standard of review known as the "business judgment rule," and the ABA guidelines. Sections 3.10 to 3.13 list the various committees that the ALI recommends. They include the Compliance and Ethics Committee, Risk Committee, Audit Committee and Compensation Committee. Each section identifies what is expected of said Committee. So in a sense, it's a general blueprint or charter, to be structured further by a corporation, to address a particular company's compliance and risk management programs.

In Chapter 5: Compliance, the focus is on compliance as the title states. In Section 5.01: Nature of the Compliance Function, it states how this fits into the governance map, viz., that compliance and risk management function are the "second line of defense." The reason is to provide strategy, deterrence, enforcement, and investigation, maintain corporate culture and proactively address ways to avoid legal liability. Section 5.11: Red Flags – specifically addresses the "red flag" (Disney case analogy) courts use to determine if the company ignored same, (i.e., an indication of a lack of good faith).

All in all, the ALI is attempting to clarify what "good faith" compliance standards are that have been misunderstood or inconsistently interpreted by a company. Put another way, the ALI points the company in the right legal direction, so that they can increase their chances for success, by reducing their legal risk profile. Convuluted case law needs to be synthesized into workable principles that directors can point to. If law demands accountability, then the law needs to be transparent to provide proper tools to abide by them. The ALI attempt to do so is a good start.

Please note that at the 2021 annual ALI meeting, the members voted to approve Tentative Draft No. 2. The vote marks the completion of the project. The ALI advisor announcement stated this is the first time that The American Law Institute has produced Principles on this area of the law, namely:

"The basis of this project comes out of the 1990s, 2000s and 2010s, where we had an enormous growth in fines and criminal prosecutions of organizations for various misconduct and misdeeds." said Reporter Geoffrey Miller. "This caused a very powerful set of discussions and set many legal minds thinking about, what is a way to both enforce the law against organizations' misconduct, but also to encourage organizations to enforce the law on themselves, through the processes of compliance."

This subject matter is one that combines legal and ethical standards. It deals with both externally imposed norms, such as laws and regulations and internally imposed norms, such as corporate codes of ethics. . . . The Principles seeks to provide best practices for a variety of public and private entities, but its main audience is large, publicly traded corporations.

“We saw that there was basically a challenge with the role of lawyers because lawyers are very involved in this process, but not always in a strictly legal role,” said Reporter Miller. “They play a role that’s more holistic and involves non-legal and legal aspects, but it challenges the basic idea of what it means to be a lawyer. There’s also three new professions that have grown up: internal compliance, risk management, and internal audit, which had been around, but it’s been professionalized.”

“It is very exciting to see the completion of this important project,” said ALI Director Richard L. Revesz.

With the approval of the draft, the project Reporters will now prepare the Institute’s official text for publication. Until the official text is published, this and previous Tentative Drafts approved by ALI’s membership are the official position of ALI, and may be cited as such.”

The above are introductory highlights that hopefully reshape the conversation on what expectations there are for directors, and how they can achieve these expectations today. They are for discussion purposes only, because state and federal statutes need to be reviewed, as well as the facts and circumstances, regarding any specific legal matter.

[7/21]