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Some Highlights of the New ABA Corporate Guidebook

There are many experts weighing in on the "new normal" of corporate governance as seen in various recent newspapers, magazines and other publications. One such organization is the American Bar Association. The ABA recently published the *Seventh Edition of its Corporate Directors' Guidebook* (2020) (1st Edition published in 1978). In the Foreword, it states, in pertinent part, that the primary purpose is "to provide practical guidance to corporate directors in meeting their responsibilities." The Guidebook focuses on the role of the individual director in its context of the duties and functions of the board, and its key committees (audit, nominating and governance, and compensation). The Seventh Edition explores the role of a director's engagement between a corporation and its shareholders. More specifically, the Foreword lists about 10 key topics. They are, generally speaking, as follows:

- engagement with shareholders,
- tension between long-term versus shorter-term strategies,
- CSR and long term value creation,
- sustainability and ESG,
- employee issues,
- board structure,
- executive compensation,
- risk management,
- crisis preparedness, and
- fiduciary duties and best practices in merger and acquisition deals.

Given the above key director issues, and current case law trends on how courts will view decisions made by a board of directors, it is important to ascertain where the ABA stands on the relevant criteria courts use to determine if the directors business decisions will be upheld or not. So in order to introduce certain key concepts, some highlights are as follows:

In Chapter 1: Overview, it states that, in pertinent part, that "the primary objective of the Guidebook is to explore and analyze how directors should devote their time and experience to the strategy and oversight of the corporation's business. . . ." It goes on further to state that "the goal is to help directors effectively fulfill their duties to the corporation . . . by explaining how they can best exercise their oversight and decision-making responsibilities, through boardroom practices and procedures, that promote effective director involvement."

In Chapter 3: Duties of a Corporate Director, it states that, "[a] director fulfills his or her responsibility through two primary board functions: decision making and oversight."

In Subpart A; BOARD DUTIES: Section 1, Responsibilities, it states that the principal board functions are "to select senior management for the corporation, plan for succession, and oversee the corporation's strategic plan and management's conducting of the business." Because state statutes do not spell out in detail these responsibilities, this section sets forth twelve (12) specific tasks the Board and its Committees should undertake. Generally speaking, they are as follows:

- monitoring the corporation performance,
- selecting key officers and management,
- development and succession planning,
- evaluating key corporate systems,
- implementing policies and procedures,
- evaluating corporate risk management,
- evaluating corporate financials,
- evaluating major transactions,
- establishing monetary compliance systems,
- monitoring fraud systems,
- engagement with shareholders, and
- evaluating the Board of Director's performance.

This section then proceeds in detail on how to do so. With regard to stakeholder constituencies, this chapter states that the board should consider the ecosystem they operate in, when making their decisions, (not just the shareholder impact) that the ABA refers to as "factors to consider in determining what is in the best interests of the corporation."

In Section 2, "<u>Legal Obligations</u>" it states that "[t]he baseline legal standard for director conduct is that a director must discharge director duties in good faith and in a manner that the director reasonably believes to be in the best interests of the corporation." The remainder of this chapter goes into detail regarding the meaning of the duty of care and duty of loyalty, and a fuller explanation of what "acting in good faith" means, with respect to the duty of loyalty in both general corporate matters, as well as control transactions and acquisitions and mergers.

So how do director duties fare with respect to the business judgment rule exemption? Section 2 (c) sets forth the ABA's opinion on same. The ABA Guidebook summarizes it simply by stating that "[j]udicial review of challenged Board decisions will normally be governed by the business judgment rule . . . [It] is not a description of a duty or a standard for determining whether a breach of duty has occurred . . . [but rather] a <u>standard of review</u> by which judges analyze director conduct to determine whether a board decision may be challenged or a director will be personally liable." Put another way, it's similar to a <u>presumption</u>, that the director acted in <u>good faith</u>, that their actions were informed, and based on an honest belief that the action was taken in the best interests of the corporation. It applies to both direct and derivative shareholder lawsuits. So, the courts have created a high bar to prevent directors from being personally liable. It further clarifies same by stating: "[I]mportantly, the business judgment rule protects only decisions whether to take or not take action involving the <u>duty of care</u>. It does not protect conduct implicating breaches of the duty of loyalty."

Given the above, the final question is: "How does the obligation to act in good faith apply to the duty of loyalty"? The ABA states, in pertinent part, under section (b), "Duty of Loyalty: Acting in Good Faith" that, "[t]he fundamental requirement of loyalty is that a director must act with the good faith belief that his or her actions are in the best interests of the corporation. A director fails to act in good faith when he or she is disloyal, either because the director's actions are motivated by bad faith, or because he or she intentionally or knowingly disregarded duties or responsibilities." This section goes on to list six (6) examples of a failure to act in good faith, including intentional actions, failure to act, acting with a conscious disregard, acting with intent to violate the law, and consciously disregarding control, risk, monitoring or compliance systems, or disregarding "red flags." As you can see, this Chapter provides a detailed overview of the board of director's obligations.

So what are a director's rights to help them comply with their obligations? Section B: BOARD RIGHTS lists a set of tools directors can avail themselves of, to ensure their decisions are in legal compliance. Simply put, a director has the right to:

- inspect the books and records,
- request additional information,
- inspect the facilities and operations,
- receive timely notices of meetings,
- receive copies of key documents, and
- receive reports on all committee activities.

In summation, the rights and obligations of directors are meant to provide both the proper guidance and the tools necessary for a director to fulfill their job.

In **Chapter 4: Risk Oversight and Compliance**, it addresses how directors can comply with their fiduciary duties and obligations. Part A: AREAS OF RISK FACING CORPORATION, it divides the areas of risk that a director may face into 3 baskets, viz., "business, legal, and reputational." In Section 2: The Role of Board Committees, it states, in pertinent part that the, "Board Committees play a role in risk oversight. Assessment and monitoring of certain types of risks may be more suited to the expertise of a particular committee. . . ." So the ABA recommends the board of directors delegate the weekly tasks of key risk compliance work to specific committees leaving the directors to provide oversight of same.

In **Chapter 6: Committees of the Board**, it states that, although a corporate board of directors can create its own types of committees, generally federal law and securities exchanges generally require audit, compensation, monitoring, and governance composed exclusively of independent directors. This chapter addresses the responsibilities of the committee members by stating: "directors serving on board committees are subject to the same duties of due care and loyalty and are entitled to the same protections of the business judgment rule as they are when acting as members of the board." The chapter goes on to describe and distinguish various traditional types of committees detailed in subsequent chapters. Lastly, a board of directors can create special and other committees to undertake a specific project or responsibility once the board of directors defines the exact scope and formation of same.

Lastly, in Chapter 10: The Relationship between the Board of Directors and Shareholders, the ABA makes clear that the "responsibility for managing the business and affairs of the corporation is vested in the board of directors. Shareholders do not have direct management rights or responsibilities under state law." Simply put, there is no "agency" relationship between the two corporate bodies. The "engagement" of shareholders with management and directors is set forth in this chapter and depends on many factors, as well as preferences between the parties, so there is no "one size fits all." Of note is Section 3, Environmental and Social Issues, which states, in pertinent part, that investors are focusing on how companies in which they invest in, address these issues (i.e., ESG), including shareholders submittal of proposals at annual shareholder meetings. Lastly, activist investors (i.e., short-term value extraction]) must also be addressed by directors, versus long-term value creation (i.e., sustainability).

(N.B. The above are introductory highlights of some "practical guidelines" that hopefully reshape the conversation on what expectations there are for directors, and how directors 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.)

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