BOARDS IN INFORMATION GOVERNANCE

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ABSTRACT

This Article charts the decline of the two leading twentieth-century paradigms of corporate governance: the agency-cost theory, which produced the limited "monitoring board," and the "separate realms" theory, which deferred consideration of all matters other than profit to government regulation. Repeated stock market crashes and hedge fund activism have exposed the limits of the agency-cost theory. A global pandemic and financial crisis, investor demands for corporate social responsibility and stewardship, and corporations' own participation in the political process have made separate realms thinking nearly irrelevant.

We argue that, while much of corporate law theory remains constrained by these twin paradigms, the practice of board governance has largely moved beyond them. The economic shock of the COVID-19 pandemic, in particular, has sent public company boards into high gear, forcing them to look beyond stock prices, to engage the firm's full capacity for information gathering and synthesis, and to actively command the firm's systems of internal and external communication. Even before a global pandemic placed heightened demands on corporate boards, the trend toward information-based governance was well underway, catalyzed by new legal requirements, industry best practices, committee charters, fiduciary duties, and investor demands for more active board governance. It has been observable in audit committees' increased participation in financial reporting, the expanding application of boards' knowledge about the firm to strategic advising and to executive compensation decisions, and boards' greater role in decision-making about risk management, legal compliance, and ESG matters.

To capture the board's investment in data gathering, deliberation, and reporting processes as constitutive of the firm's status, and the board's strategic management and authoritative deployment of knowledge and communication, we label this new board governance "informational governance." Informational governance includes a robust role for corporate boards in communicative action—the active creation and deployment of the firm's self-knowledge—recognizing an important, value-creating role for boards that has long been discouraged by the "monitoring board" conceit. Focusing on informational governance helps sharpen our understanding of the board's role in corporate strategy, an overlooked subject in the corporate law literature, but one that has assumed new importance in the post-pandemic era. We identify some areas in which the law is likely to evolve as this new, technologically-enhanced, information-rich paradigm continues to cohere.

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INTRODUCTION

The COVID-19 pandemic and stock market crash of March 2020 have altered the urgency and tone of our national conversation about corporate governance, while increasing the demands placed on boards of directors.[1] Amidst this tumult, boards are seeking fresh guidance regarding their roles, but the existing governance paradigms are proving threadbare. In this current financial crisis, it is insufficient to instruct boards that good governance is founded on reading stock prices as benchmarks of corporate success. In these uncharted waters, "agency cost" board governance provides little guidance to directors. Even in the warming, post-*Citizens United* world that preceded the COVID-19 pandemic, it was not reasonable for boards to fend off concerns about social welfare to a separate realm of governmental action. In sum, both the agency cost and separate realms paradigms for board leadership have come up short. As companies face dynamic, unprecedented challenges, active board governance is resurgent, and old governance dogma demands reconsideration.

This Article argues that we are witnessing a shift away from the "monitoring" board model and the "separate realms" paradigm, both of which masked the true scope of board responsibility and discretion in corporate affairs. We propose the term "informational governance" to describe this new model of emerging board governance in the Information Age. Informational governance highlights the board's authoritative deployment of knowledge and communication systems to ground rational collective action in the firm. This corporate self-knowledge, emerging under the board's leadership, is the basis for building the firm's strategic, organizational, and ethical identity.

In this Article, we present informational governance both as a normative theory about the role of boards in governance—an answer to the question: "What should boards do in governing the twenty-first-century firm?"—and as a descriptive framework for understanding changes in corporate governance already underway. That is,

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[1] For a summary of the "seismic" changes creating an "urgent imperative" for board leadership, see NATIONAL ASSOCIATION OF CORPORATE DIRECTORS, REPORT OF THE NACD BLUE RIBBON COMMISSION, FIT FOR THE FUTURE: AN URGENT IMPERATIVE FOR BOARD LEADERSHIP (2019) [hereinafter, NACD, URGENT IMPERATIVE], at 8.

informational governance offers a new and better theory about what boards *should be doing*, and therefore how corporate governance law should evolve—while describing more accurately what boards *are doing now*, and how law helped us get to this place. For decades the agency-cost paradigm offered an economic framework upon which corporate governance was built. Informational governance offers a new, superior framework for building corporate governance, one made possible—made *necessary*—by advances in information technology and enhanced stakeholders' demands; informational governance also offers a better framework for understanding corporate law *as it is evolving presently*.

In the agency-cost theory of board governance, the board served as the actor at the top (or center) of the organizational chart—the "nexus" in a nexus of contracts or the "mediating hierarch" in a team production model.[2] Its main job was to ensure that neither management nor shareholders extracted private benefits at the expense of the other. Monitoring was accomplished through a finite set of board tasks, such as reviewing CEO performance and executive pay, umpiring the firm's extraordinary transactions, and scrutinizing any self-dealing. In order to be "efficient" (a key to agency-cost reduction), the mandates of board governance were trimmed to the bone. Limiting the mandate and work-load enabled individual directors to serve on multiple big-company boards, and hence perpetuated an inner circle of directors constituted especially from the ranks of current and recently retired CEOs.[3] The influence of agency-cost thinking on corporate governance theory is difficult to overstate. Even today, academic governance reform proposals stay safely within the agency-cost box, offering little more than tweaks to a framework in which boards play a mostly passive, monitoring role.

Informational governance recognizes that the political-economic mandate for public company boards has moved beyond the reduction-of-agency-costs model. It re-conceptualizes board governance in twenty-first-century firms as communicative action. Deciding what the firm will measure, value and communicate, internally and publicly, catalyzes coordinated action in complex enterprises such as public companies. Board judgment about what will (or will not) be measured, approved, and closely observed, echoes

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[2] Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

[3] On the persistence of corporate inner circles, see James Fanto, *Whistleblowing and the Public Director: Creating Corporate Inner Circles,* 83 OREGON L. REV. 435 (2004). For a sociological, behavioral and statistical analysis, see Bang Dang Nguyen, *Does the Rolodex Matter? Corporate Elite's Small World and the Effects of Board of Directors*, 58 MANAGEMENT SCIENCE 236 (2012).

through the organizational life of the firm, especially in a world where ESG concerns are compounding.[4] Informational governance does not dictate a conclusion for directors about stakeholder versus shareholder governance, or any other endpoint of corporate identity.[5] Alternatively, it posits that, boards create value in embracing the uniqueness of their firm—marshaling its information and communication systems to foster clarity and direction (internally and externally) about the strategic and organizational possibilities defining the enterprise.[6]

The core insight of informational governance theory is that the board's investment in data gathering, reporting, deliberation, and conscientious delegation of authority generates value for the firm. The board is not merely monitoring the value-creating work of others to vanquish agency costs. Rather, it is *itself* creating value by participating in identifying the firm's core areas of competitive advantage, including its ESG capabilities.[7] We analyze three facets of informational governance in action. First, consistent with *Caremark* duties, boards engage in informational governance in the deliberative construction and persistent improvement in the firm's internal data gathering, reporting and communications architecture.[8] This is exemplified, most graphically, by the work being done by audit committees in financial reporting, and risk and legal compliance governance. Second, the

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[4] The informational governance concept draws on the literature of organizational identity formation in management science and organizational behavior. The foundational text is Stuart Albert & David A. Whetten, *Organizational Identity*, 7 RES. ORGANIZATIONAL BEHAV. 263 (1985) ("It is the answer that members of the organization give to the question 'who are we?' or 'what do we stand for?' as an organization"). *See also* Joep P. Cornelissen, S. Alexander Haslam & John M. T. Balmer, *Social Identity, Organizational Identity and Corporate Identity: Towards an Integrated Understanding of Processes, Patternings and Products*, 18 BRITISH J. MGMT. 1, 3 (2007) (defining organizational as "relating to the identity of the organization as a whole"); Dennis A. Gioia et al., *Organizational Identity Formation and Change*, 7 ACAD. MGMT. ANNALS 123, 124-25 (2013) (reviewing the literature on organizational identity).

[5] There is considerable irony in corporate governance law's fervent embrace of corporate self-regulation and "enabling" law, on the one hand, while taking a monolithic approach to profit maximization for shareholders being the (legal and economic) purpose of business corporations.

[6] For perhaps the most influential early treatment of organizational identity as it shapes the choices of an enterprise's leadership team, see Dennis A. Gioia et al, *Organizational Identity, Image and Adaptive Instability*, 25 ACAD. MGMT. REV. 63 (2000). And on the importance of disclosure in relation to theories of building corporate identity, see, e.g., Stanaland, Lwin and Murphy, *Consumer Perceptions of the Antecedents and Consequences of CSR*, 102 J. BUS. ETHICS 47 (2011).

[7] On the link between competitive strategy and CSR, see, e.g., Porter, M.E. and Kramer, M. R., *Strategy and Society: The Link between Competitive Advantage and Corporate Social Responsibility*, 84 HARV. BUS. REV. 78 (2006).

[8] The empirical literature attesting to the link between internal auditing (effective internal controls) and corporate performance is growing. *See, e.g.*, Ma'Ayan & Carmeli, *Internal Audits as a Source of Ethical Behavior, Efficiency and Effectiveness in Work Units*, 137 J. BUS. ETHICS 347 (2016).

financial, legal, and operating information garnered by audit committees furnishes the basis for the board's role in advising on strategy formation, evaluating the CEO, and setting executive compensation. Third, risk oversight and legal compliance lay a basis for the full board's decisions regarding organizational culture, including the firm's responses to ESG shareholder proposals.[9] Coherent corporate cultures, including ESG policies, reinforce productive collective action, as well as stakeholder loyalty—both sources of value for the firm. In documenting the emergence of active board leadership consistent with our informational governance model, we validate the need for boards to shift to an expansive value-creation mindset, rather than an *ad hoc*, passive, or compliance-based one.

We also validate the need for corporate governance law to provide a supportive scaffold for boards engaged in informational governance. We build on already existing legal and pragmatic requirements—for example, committee charter requirements imposed by stock exchanges—in elaborating the board's role in evaluating information gathering and corporate communications. The board's treatment of the full range of corporate communications, mandatory and discretionary—for example, the chosen methods of quantitative and textual financial reporting, the release of ESG reports (or not), or even accounts of corporate philanthropic or political activity (or not)[10]—will shape the firm's culture, its organizational identity, and hence its future.[11]

Informational governance incorporates a robust role for the board in vetting and advising on strategy, as initiated by the CEO.[12]

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[9] A common response is for the firm to capitulate to the proposal before it comes to a formal proxy vote. *See* Sarah C. Haan, *Shareholder Proposal Settlements and the Private Ordering of Public Elections*, 126 YALE L.J. (2016).

[10] No existing body of law or regulation requires public disclosure of corporate donations to nonprofits, including gifts to highly politicized think tanks. *See* Faith Stevelman Kahn, *Pandora's Box: Managerial Discretion and the Problem of Corporate Philanthropy*, 44 UCLA L. REV. 579 (1997) (exploring practices and substantive rules). The law in the area has not altered.

[11] There is an expansive empirical literature exploring the practical effect of organizational identity. *See, e.g.*, Susanne Scott & Vicki Lane, *A Stakeholder Approach to Organizational Identity*, 25 ACAD. MGMT. REV. 43, 47 (2000) ("Managers choose organizational images for presentation to stakeholders for strategic reasons. Corporate reputation building is principally concerned with promoting attractive organizational images for purposes of goal attainment, and it is the primary job of leadership to manage organizational identity toward that end.").

[12] The monitoring paradigm of board service has been so pervasive that empirical analysis of boards' contribution to strategic advising and strategic outcomes is still emerging. For recent examples examining boards' strategic advisory role, see, e.g., Meyernick, Oesch and Schmid, *Is Board Industry Experience Valuable?* 45 FIN. MGMT. 207, 208 (2016) (Finding far greater support for directors having relevant industry experience and noting that: "In fact, surveys conducted among directors suggest that

Such an advisory role is especially valuable where directors' investment in understanding internal corporate data is complemented by relevant industry experience—a factor which should influence Nominating Committee choices. We argue that there is value, even, in the board requiring the CEO to present (for discussion) a coherent, informed vision and plan for maximizing the firm's competitive advantage. Fortunately, many well-functioning boards are already engaging in the dimensions of informational governance we illuminate. Yet we anticipate that the informational governance nomenclature will be useful to directors and commentators in its clarity. Nevertheless, informational governance offers more than just a new piece of jargon—it represents a new theory about how boards leverage information and communications to create value for their firms.

The Article is organized into two parts. Part I describes the fall of the twin paradigms of twentieth-century corporate governance. It argues that agency-cost governance—with its signal goal of maximizing shareholders' wealth—has fallen short on its own terms. The Great Stock Market Crash of March 2020 has put to rest any notion that stock prices provide reliable signals about firm performance and value. Without a thorough understanding of what the firm is, has been, and can be, boards come up short in judging the relative merits of the CEO's vision and the vision of insurgent activists.

In addition, we argue that "separate realms" thinking has been an ideological iron cage. The notion that companies exist only to generate profits, with government handling "the rest," has been a longstanding feature of corporate neoliberalism, although it has remained largely invisible, even unnamed in corporate governance.[13] ("Separate realms" is our nomenclature, and a novel contribution of this Article.) As the distinction between "financial" and "nonfinancial" corporate information has eroded—and as the COVID-19 pandemic has exploded stakeholder demands—the flaws in separate realms thinking are manifest. With mounting stakeholder interest in ESG concerns, and increasing recognition of ESG "risk," the separate realms conceit has lost credibility. Moreover, corporations' own visible

directors consider the advisory role and their legal duty to review the corporation's major plans and actions to be of greater importance than their monitoring role." (citations omitted)); *Synergies Between the CEO's and the Board's Human and Social Capital*, 35 STRAT. MGMT. J. 845, 849 (2014). Emphasis on the friction between monitoring and advising exists in the legal academic literature, as well as finance. *See* Sundaramurthy and Lewis, *Control and Collaboration: Paradoxes of Governance*, 28 ACAD. MGMT. REV. 397 (analyzing tradeoffs between the control and collaboration approaches to board leadership).

[13] For an excellent history of neoliberalism's core ideas and influence on political economy, see Centeno and Cohen, *The Arc of Neoliberalism*, 38 ANN. REV. SOC. 317, 328 (2012).

efforts to shape law and regulation in their favor reveals the illogic in separate realms thought. Public companies' success in achieving deregulation—in winning freedom to self-regulate—has unleashed the visibly powerful, "self-choosing" corporation.[14] We propose board informational governance, and greater transparency attending it, as one response.

Part II presents the core of the informational governance thesis, expanding on the brief sketch presented here. An initial subsection describes how advances in information technology have contributed to legal and practical trends favoring more active, informationally-focused board governance. To illustrate informational governance in greater detail, it next considers the evolution of audit committee governance since the 2000s, including the board's deepening role in governing risk management and legal compliance. Part II then demonstrates how the informational governance approach provides a better basis for the board's role in strategy formation, and CEO evaluation and compensation. Relatedly, a company's ESG posture will be informed by all the aforesaid—its financial status, risk tolerance, legal compliance efforts and overall strategies. Because ESG decisions flow from the other critical domains of governance, they demand board level attention.

Informational governance lays the groundwork for a twenty-first-century approach to board fiduciary duties, one emphasizing information and communications management. The final subsection of Part II highlights three fiduciary doctrines immediately relevant to informational governance. First, in a world of vastly enhanced information technology, boards must rethink fiduciary care's mandate to "inform themselves of all information reasonably available." Second, the fiduciary duty of candor (which applies to director and officer conduct at all times) bears on "reporting up the ladder" communications, as well as public reporting. But especially trenchant are evolving *Caremark* duties, which are reshaping board governance over information systems and risk and legal compliance governance.

The impetus for this Article is the shared instinct that we are being thrust into a new corporate governance reality, though it is has not elsewhere been expressed as a breakdown of agency cost and separate realms paradigms. The new milieu could be denominated as "third wave" (or post-pandemic) governance.[15] Third wave

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[14] *See* Martha McCluskey, The Substantive Politics of Formal Corporate Power, 53 BUFFALO L. REV. 1453 (2006).

[15] *See, e.g.*, Lynne L. Dallas, *Is There Hope for Change? The Evolution of Conceptions of "Good" Corporate Governance*, 54 SAN DIEGO L. REV. 491, 552 (2017) (concluding that there is "considerable support for the emergence of a new conception of corporate

governance more candidly acknowledges the power and discretion of corporate boards, and the power and discretion of global corporations. The concept of informational governance, and board leadership as communicative action, emphasize the freedom and also new responsibilities that corporations possess in the Information Age.

I.

THE FALL OF THE TWIN PARADIGMS OF TWENTIETH-CENTURY CORPORATE GOVERNANCE

A. The Pitfalls of Agency-Cost Board Governance

Berle and Means raised agency questions about the widely-held firm as far back as the 1930s, but it was not until the 1970s and '80s that agency-cost corporate governance began its hegemonic reign.[16] The agency-cost paradigm presents boards as passive monitors with little need for deep knowledge about firms; boards engage in a narrow set of tasks that emphasize stock-price benchmarks. Ironically, although agency-cost theory shaped board function within the discipline of "corporate governance," the field was not really about governance at the individual firm level. Rather, the focus was principally on enabling market therapeutics to operate as disciplinary devices against errant corporate managers. Directors were charged with monitoring managerial self-dealing and indolence in order to limit waste. But takeovers served a similar function, eliminating waste via new management. Market-based, stock option compensation was used to align CEO, and even directors' incentives, with those of shareholders.[17]

Meanwhile, agency-cost governance shed little light on the "inside" of firms, where board governance occurs.[18] Delaware's loose

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governance"); *Symposium: The Future of the Corporation*, 6 J. BRIT. ACAD., December 2018/ [31 October 2018, *Reforming Business for the 21st Century: Findings from the first phase of the British Academy's 'Future of the Corporation' research programme*, edited by Colin Mayer (volume 6, supplementary issue 1)]. International Business Council of the World Economic Forum, *The New Paradigm, A Roadmap for an Implicit Corporate Governance Partnership between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth*, Wachtell Lipton, available at http://www.wlrk.com/docs/thenewparadigm.pdf

[16] *See* Adolf A. Berle, Jr., & Gardiner C. Means, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

[17] Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002) (reviewing large body of empirical work on executive compensation and finding labor market failures in executive incentive compensation plans).

[18] An alternative empirical tack was taken in management science, where an enormous stream of research, under the rubric of "in-put/out-put studies," attempted to discern linkages between board composition (gender, age, educational

fiduciary standards operated as the principal heuristic for board governance until the 2000s, when public demand for better governance led to the passage of the Sarbanes-Oxley Act and the Dodd-Frank Act. Yet the new demands these statutes placed on boards were read, unfortunately, as *compliance* imperatives, not in terms of governance for value.

As we show, boards who were sold the agency cost/monitoring board paradigm rarely became deeply informed about their firms. In the most extreme, recent version of shareholder value contestation, where activist hedge funds present an alternative strategic plan, boards are finding that agency-cost theory has left them lacking the strategic depth to do their jobs. Agency-cost boards generally lack the information to discern whether to assent to or refuse the activists' demands. Yet under the basic tenets of corporate law, board assent is needed. Under agency theory, board monitoring of managerial conflicts was considered the key to maximizing shareholder value, but as the confrontation with activists is demonstrating, its prescription for value maximization is entirely too limited. Boards can play a larger, more vital role in creating value if they govern the firm's enterprise-salient information gathering, reporting and communications to build a corporate identity that inspires concerted action.

1. The Agency-Cost Paradigm of Board Monitoring

Dating from the publication of the *Modern Corporation and Private Property*, in 1932, American academic corporate law writing focused on the implications, for shareholders, of the "separation of ownership from control."[19] Adolph Berle, Jr., a Columbia law professor, and Gardiner Means, an economist, observed the growing remoteness of shareholding from hands-on management in large corporations in the United States. Importantly for legal academics, who have been highly influential in building the corporate governance field, corporations continued to be conceived of essentially in shareholder- property terms. In the ensuing decades, the shareholder-property orientation of corporate governance synchronized nicely with

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background) and governance and firm characteristics (diversification, size, structure, levels of monitoring, etc.). *See, e.g.*, Westphal and Stern, *Flattery Will Get You Everywhere (Especially If You Are A Male Caucasian): How Ingratiation, Boardroom Behavior, And Demographic Minority Status Affect Additional Board Appointments at U.S. Companies*, 50 ACAD. MGMT. J. 267 (2007).

[19] Adolf A. Berle, Jr., & Gardiner C. Means, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932); Brian R. Cheffins, The Rise and Fall (?) of the Berle-Means Corporation, 42 SEATTLE U. L. REV. 445, 445-6 (2019) (discussing the "enduring legacy" of the concept).

the rising influence of law-and-economics corporate academic research.[20]

Prior to the late 1970s, the gulf separating dispersed shareholders from managerial control was conceived of as a fundamental harm—a vulnerability arising from the "explosion of the atom of [shareholder] property."[21] The persistent concern was, in simplified form, that shareholders' property value would succumb to the agency-cost nightmares arising from professionalized corporate management: self-dealing and indolence. Nevertheless, directors were mostly contented to be situated in a clubby relationship with CEOs, who retained enormous (if not complete) influence in their selection, and corporate law did little to alter that dynamic, despite many commentators' objection.[22]

From the 1980s onward, the writings of financial economists Fama and Jensen[23] and Jensen and Meckling[24] proved highly influential in the development of modern corporate law. In a remarkable reversal, the separation between the financing function and the managerial-control function was reconceived as an "*efficient,*" positive specialization.[25] Monitoring by independent directors became the tip of the corporate-accountability-to-shareholders spear. Boards engaged in "ratification and monitoring of [corporate] decisions" to promote shareholder value. The C-Suite acquired the executive function, the "initiation and implementation of [corporate] decisions" to promote shareholder value. Courts hesitated to review corporate transactions approved by independent directors, *a fortiori* to apply legal sanctions when corporate affairs turned out badly. Market forces and incentives, rather than legal rules and judicial enforcement, were conceived of as exerting the optimal, efficient form of discipline on corporate managers.

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[20] For a brief history of the law and economics movement's influence on legal thought, see GARY MINDA, POSTMODERN LEGAL MOVEMENTS: LAW AND JURISPRUDENCE AT CENTURY'S END (1995).
[21] Adolf A. Berle, Jr., & Gardiner C. Means, THE MODERN CORPORATION AND PRIVATE PROPERTY 9 (1932).
[22] For the classic objection see William Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974).
[23] *See* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 301-02 (1983)] (rebutting Berle and Means's analysis by arguing that organizations where ownership and control are separated survive because they benefit from specialization of these roles and are able to control agency problems by separating "the ratification and monitoring of decisions from initiation and implementation of the decisions").
[24] *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).
[25] EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991); Daniel R. Fischel, *The "Race to the Bottom" Reconsidered: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913 (1982).

Reliance on stock prices and outside, professional experts shielded directors from having to do "too much" work.[26] It also thinned the base-line standard of director experience, and what directors were expected to learn about their firms—hence what "monitoring" meant. Lost was the value that might have accrued if experienced directors had commanded robust systems of information-gathering and reporting within the firm, and then invested themselves in deliberating over, discussing, and following up on the information that was produced.

Curiously, the agency-cost paradigm was not an obvious fit for corporate law and governance. Under U.S. law, neither directors nor executives are agents of shareholder-owners. Directors' authority is statutory and plenary, and officers' authority is delegated from the board.[27] Nor can shareholders rightly be conceived of as owners of corporate property, as opposed to residual risk bearers—the corporation itself owns its property.[28] Nevertheless, consistent with the conceit of directors being their agents, profit maximization for shareholders became the nearly exclusive focus of directors' and officers' duties in modern corporate governance.[29] For forty years, moreover, shareholder profit maximization was used as a proxy for enhancing social welfare, as consideration of the separate realms concept (below) illuminates.[30]

Influenced by the law-and-economics focus, and the financialization of the field, corporate legal academics validated managers' laser-focused attentiveness to stock prices as signals of

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[26] As just one example, before the agency-cost paradigm took hold, the typical public company board met much more frequently than has become the norm. A transcript of Standard Oil Company (New Jersey)'s 1945 annual meeting reveals that the company's board met "every week," with "committee meetings practically every day." Standard Oil Company (New Jersey), Stenographic Record of the Annual Meeting, June 5, 1945 (Standard Oil Co., 1945), at 8.

[27] DGCL § 141; DGCL § 142; LYNN STOUT, THE SHAREHOLDER VALUE MYTH 42-44 (2012); Faith Stevelman, *Myths about Shareholder Value*, Accounting, Economics, and Law: A Convivium, Vol. 3, Issue 1 (March 2013), pp. 1-14.

[28] *See* Stout, at 37-38. For a recent treatment of the reformulated shareholder concept and its implications for corporate law, see Kelli A. Alces, *Revisiting Berle and Rethinking the Corporate Structure*, 33 SEATTLE U. L. REV. 787 (2010).

[29] LAWRENCE E. MITCHELL, PROGRESSIVE CORPORATE LAW (1995); Marleen O'Connor, *Labor's Role in the American Corporate Governance Structure,* 22 COMP. LABOR LAW & POL'Y J. 97 (2000); David Millon, *New Directions In Corporate Law: Communitarians, Contractarians, And The Crisis In Corporate Law*, 50 WASH. & LEE L. REV. 1373 (1993).

[30] William W. Bratton, *Shareholders and Social Welfare*, 36 SEATTLE U. L. REV. 489 (2013); William W. Bratton, *The Separation of Corporate Law and Social Welfare*, 74 WASH. & LEE L. REV. 767 (2017).

corporate performance.[31] There was a nearly universally shared, albeit implicit presumption that favoring independent, non-management directors involved, by necessity, settling for ones who could understand relatively little about their firms. Favoring directors who brought impartial judgment to monitoring conflicts, but thin knowledge of corporate affairs, remained plausible because directors were instructed to rely on stock market prices as indicia of corporate failure or success.

Armed with solid faith in capital (and other) markets as the determinants of corporate survival and success, and with a gimlet eye on shareholder value, the "deregulation" of corporate law continued until the federal interventions of the 2000s.[32] Calls for federal action to ensure minimum fiduciary standards had been beaten back thirty years previously, criticized as rigid and ill-conceived.[33] A 1989 symposium edition of the *Columbia Law Review* questioned, even, whether *any* corporate law rules should be mandatory.[34] Agency-cost governance encouraged boards to take a narrow, reductive approach to the treatment of employees, risk management, and even legal compliance.[35] The SEC interpreted its shareholder proposal system so as to exclude most social, environmental, and political resolutions from the corporate proxy—ignoring their capacity to serve as valuable harbingers of reputational peril and promise. Shareholder diversification was vaunted as the optimal mode of shareholder self-help. Leveraged buyouts and restructurings were lauded as efficient solutions to excess free cash flow that might encourage managerial waste. The favor shown stock-based executive compensation illustrates how the emphasis on market forces obscured closer scrutiny of organizational behavior and boards' capacity for corporate leadership.[36] In short, the field of corporate governance stubbornly

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[31] *See generally* Jeffrey 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).

[32] Then Stanford Law School dean Bayless Manning described corporate law as having "nothing left but our great empty corporation statutes–towering skyscrapers of rusted girders, internally welded together and containing nothing but wind." For a historical account of the early development of corporate law, see Harwell Wells, *The Modernization of Corporate Law*, 11 U. PA. J. BUS. L. 573 (2009).

[33] For discussion of such a potential federal initiative, see, e.g., Jennings, *Federalization of Corporation Law: Part Way or All the Way*, 31 BUS. L. 991 (1976); Schwartz, *Symposium-Federal Chartering of Corporations, An Introduction*, 61 GEO. L.J. 71 (1972).

[34] *Symposium: Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. (1989).

[35] Cynthia Williams, *Corporate Compliance with the Law in the Era of Efficiency,* 76 N. C. L. REV. 1266 (1998) (discussing how legal compliance was recast as a choice, so that firms could legitimately choose to expense noncompliance).

[36] In the same vein, hostile takeovers and leveraged buyouts were lauded by academics and shareholder representatives as efficient solutions to excess free cash flow or managerial waste—instances where incumbent managers failed to maximize shareholder value.

avoided looking inside the "black box" of corporate affairs where actual governance occurred.

Upending the usual hierarchy of statutes versus case law, Delaware's loose fiduciary standards served as the principal legal constraint on board action until the 2000s. Nevertheless, thanks to the business judgment rule, these fiduciary duties obtained bite almost exclusively in the context of high stakes M&A transactions. Outside M&A deals, few shareholder derivative lawsuits against executives or directors survived motions to dismiss.[37] Departing from the director-as-trustee model, even duty of loyalty lawsuits were largely curtailed by judicial ascent to "cleansing of the taint" votes by non-management directors.[38] Duty of care lawsuits against directors disappeared after the rise of charter exculpation clauses after the mid1980s.[39] The path through the fiduciary maze was cleared by faith in market forces.

There was, nevertheless, plenty of governance work for investment bankers and lawyers to do in advising boards. M&A deals, of course, involve intensive advising about alternative legal structures, financing options, comparative bid values, auction modalities, poison pill mechanics and so forth. Hostile tender offer bids and takeover defense involve high stakes (and highly lucrative) board transactional advising. Executive compensation plans and stock buybacks, similarly, involve extraordinary transactional complexity, executed under the board's legal authority, with the advice of expert bankers, lawyers and consultants. Academics in corporate governance sought market validation of the working-horse mechanical-legal devices employed in the M&A context (poison pills, staggered boards, special committees, especially). But academic studies failed to reach clear conclusions about the merits of particular governance mechanisms based on event studies.[40]

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[37] Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133 (noting the paucity of duty of care and duty of loyalty derivative actions outside of the M&A context).

[38] The apex of this validation of private ordering was reached when the Delaware courts allowed for deferential business judgment rule review of controlling shareholder transactions, so long as they're conditioned on preapproval by a majority of directors and shareholders. For opposition to this degree of judicial laissez faire based on corporate self ordering, see Faith Stevelman, *Going Private at the Intersection of the Market and the Law*, 62 BUS. LAW. 775 (2007); *but see* Guhan Subramanian, *Fixing Freezeouts*, 115 YALE L.J. 2 (2005) (validating the move to deferential business judgment review).

[39] *See* Geoffrey P. Miller, *A Modest Proposal for Fixing Delaware's Broken Duty of Care*, 2010 COLUM. BUS. L. REV. 319 (2010).

[40] A recent empirical study demonstrates the weak or nonexistent link between choice of Delaware incorporation and corporate advantage. *See* Robert Anderson, *The Delaware Trap: An Empirical Analysis of Incorporation Decisions* 91 S. CAL. L. REV. 657 (2018).

Hence, beyond contract, property, command (hierarchy), and market signals, agency-cost governance had little to offer individual boards making choices in governance at individual firms. Inside-the-firm governance, especially leaving aside securities and M&A, remained curiously distinct from governance research and theorizing from the agency-cost perspective. The historical view is intended to illuminate that the agency-cost/monitoring board was part of an era, not an inevitable feature of corporate governance.[41] As technology, investor demands and the socio-political landscape evolve, so must board governance.

2. Expanded Board Informational Tasks under Federal Law

Over the 1990s, so-called "soft law" took boards' informational duties in governance more seriously. The stock exchange listing requirements and various industry compendia of best board practices demanded that public companies establish audit, compensation and nominating committees. Here too the emphasis was on service principally by outside directors.[42] The committee reformulations required enhanced mastery of firm-specific information by directors. But (perhaps in line with the disclosure focus of the securities laws) commentators, advisers, and directors themselves mostly adopted an *ad hoc*, transactional view of this committee work. The new board efforts were framed as (mere) *compliance*, rather than *governance*. Even worse, they were too commonly viewed as a drag on efficiency, rather than a foundation for board value creation within firms.[43] The monitoring board model did not require functional board committees. Even in regard to audit committees, with the onus on auditors and management in financial reporting, board oversight was far from intensive, prior to Sarbanes Oxley. Preferring loose, equitable standards to rules and requirements, leaders in corporate governance mostly derided the new mandates, while advisers and consultants stepped up to assist boards with the burdens of complying with the new committee mandates. The SEC's hands were mostly tied up through the 1990s, since the securities laws were mostly confined to enhancing transparency.

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[41] We are not the first scholars to suggest that the agency-cost paradigm has lost its luster. *See, e.g.*, GERALD DAVIS, THE VANISHING AMERICAN CORPORATION: NAVIGATING THE HAZARDS OF A NEW ECONOMY (2016).

[42] For a comprehensive treatment of the New York Stock Exchange amendments and new standards, see Simpson, Thacher and Bartlett, *NYSE Board of Directors Approves New Corporate Governance and Disclosure Standards*, 9 LAW & BUS. REV. AM. 63 (2003).

[43] The most striking example was Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L. J. 1521 (2005). For a somewhat more sanguine view, see Lawrence Cunningham, *The Sarbanes Oxley Yawn: Heavy Rhetoric, Light Reform (and it Might Just Work)*, 36 U. CONN. L. REV. 915 (2003).

Even with the series of large-scale accounting scandals in '01-'02, the importance of board stewardship of firm information as a mode of corporate value creation failed to take hold at the level of governance theory and scholarship. True, the scandals lead to federal legislation compelling greater board attentiveness to sound corporate accounting and auditing practices, especially by board audit committees. But even with the enactment of *Sarbanes Oxley,*[44]and the ensuing SEC regulations, the focus was on *particular tasks* directors were to perform to benefit *capital markets investors*—not on management of the firm to benefit the enterprise in a broader sense. In this respect, the new securities laws, including the new audit committee provisions, built upon and extended the conventions of agency-cost governance to support market forces as the principal therapeutic for governance shortfalls. The federal orientation described above was extended in the *Dodd Frank Act* of 2010.[45] The governance provisions of *Dodd Frank* emphasize the role of independent directors in reducing managerial conflicts, excessive executive compensation, and incipient corruption, for example by prohibiting retaliation against whistle-blowers.[46] In essence, they codify features of state corporate law's fiduciary proscription against self-dealing, the paradigmatic agency cost.

In sum, after the turn of the millennium, federal laws, regulations, and stock exchange requirements built on the agency-cost paradigm by extending the role of director committees to limit managerial corruption and foster market transparency. But federal law's myopia about the potential for committee work to serve broader governance objectives, and state commentators' disdain for federal rule-making, together produced another lost opportunity to recognize a comprehensive role for directors in managing corporate information and communications to enhance firm value. Nowhere in federal securities law is there anything that recognizes the role of directors in fostering and shepherding corporate information and communications along the lines of informational governance —that is, as part of defining what the firm is, and might become, in order to thrive.

3. New Information Technologies and Emergent Duties

[44] Sarbanes-Oxley Act of 2002, 116 Stat. 745. Pub. L. No. 107-204, 2002 U.S.C.C.A.N. (116 Stat.) 745. For a detailed treatment of Sarbanes Oxley's codification of enhanced director oversight in areas relevant to accurate reporting and fraud prevention, see J. Robert Brown, *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317 (2004).

[45] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[46] *See* Nizan Geslevich Packin & Benjamin P. Edwards, *Regulating Culture: Improving Corporate Governance with Anti-Arbitration Provisions For Whistleblowers,* 58 WM. & MARY L. REV. ONLINE 41, 46 (2016-2017).

Two new developments in the final years of the twentieth century brought pressure to bear on the established legal structures of agency cost governance. First, vastly enhanced computing power and communications technology radically expanding the capacity for boards to become informed about and monitor corporate affairs.[47] This revolution in governance capability has been surprisingly thinly examined. In the years immediately following 1985, when the Delaware Supreme Court admonished boards to "inform themselves of all information reasonably available," cumbersome centralized computing gave way to elegant personal computers. The new technology vastly enhanced the speed and ease of executives sharing even highly detailed, lengthy corporate data and reports. After the mid-1990s, the Internet had a revolutionary impact on commerce and corporate affairs, including the rise of near-instant communication by electronic mail, instant messaging, voice over Internet Protocol (VoIP) telephone calls, two-way interactive video calls. The communications made possible by the "flip phones" of the 1990s look primitive compared to the smartphones pervasive among executives today. Companies made enormous investments in computerized internal controls, the tip of the corporate information-revolution iceberg being state of the art corporate webpages designed to project their image.

Beginning in the mid-1990s, the SEC first enabled and then required electronic filing of corporate reports, which soon became comprehensively available to investors and other publics via the web—including through companies' own webpages. As instantaneous communication of sophisticated data became not only possible but normal, the meaning of the board's obligation to be informed of "all information reasonably available" changed—in practice. Surely directors themselves would know their firm better than could outside investors reading the firm's public reports. But, in fact, legal change in directors' fiduciary-based informational duties had stalled. The nearly universal adoption of charter exculpation provisions after the mid-1980s, stunted the development of the duty of care's mandate.

Moreover, an artificial but widely observed distinction separated directors' obligations to become informed about overall corporate affairs from their obligation to become informed about the host of disclosures to shareholders they oversaw. It was not until 1998, in *Malone v. Brincat*, that the Delaware Supreme Court reversed this supposition (and the Court of Chancery's decision), finding that directors' owed a duty of care and loyalty in their oversight and

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[47] *See, e.g.*, TIM WU, THE MASTER SWITCH: THE RISE AND FALL OF INFORMATION EMPIRES (2011) (surveying the invention and development of the internet) and *How Apple's iPhone Changed the World: 10 Years in 10 Charts,* at https://www.vox.com/2017/6/26/15821652/iphone-apple-10-year-anniversary-launch-mobile-stats-smart-phone-steve-jobs.

participation in filing accurate and complete annual and quarterly reports to investors.[48] Nevertheless, a host of predicates and complexities in the court's decision thwarted the expansion and utility of this so-called "duty of candor."

Boards' fiduciary duties in the informational context took yet another tentative step forward in 1996, the Delaware Court of Chancery veered away from the narrowed confines of fiduciary care and loyalty to identify new substantive board duties related to the quality of internal control (i.e. internal corporate information gathering and reporting systems).[49] Unfortunately, for two decades *Caremark's* take-away for boards remained ambiguous. First, its precedential value was unclear because the opinion merely adjudicated a settlement of shareholder derivative claims. But even more unsettling was the opinion's jurisprudential foundation. Although *Caremark* grounded new, systematic, informational (internal control oversight) duties in fiduciary care doctrine, it called for directors to make *a good-faith* effort to promote their firms' internal control infrastructures. As stated therein, only "an utter failure to assure a reasonable information and reporting system exists will establish *the lack of good faith* that is a necessary condition to [director] liability."[50] Immense difficulty and high stakes lay in the distinction. Duty of good faith jurisprudence was opaque,[51] and failures of good faith (bad faith) was not susceptible to charter exculpation.[52]

Within the legal and governance advisory field, concerns over potential expanded director liability and the relevance of the duty of good faith (versus the duty of care) created deep wariness regarding *Caremark*'s application. Especially in its ambiguous relation to charter

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[48] *Malone v. Brincat*, 722 A.2d 5 (1998). For discussion of the relationship between boards' fiduciary duties and the federal disclosure mandates, see Faith Stevelman Kahn, *Transparency and Accountability: Rethinking Fiduciary Law's Relevance to Disclosure,* 34 GA. L. REV. 505 (2000).

[49] *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996). Chancellor William Allen reasoned that the duty of care extended beyond directors merely informing themselves in an *ad hoc* manner. He advised that directors' fiduciary duties require them to be proactive in installing and overseeing efficacious internal controls—controls capable of fostering information germane to accurate external reporting as well as legal compliance and risk-management. Even more fundamentally, he noted that efficacious internal controls produce the information requisite to the board's fulfillment of its essential monitoring and managing responsibilities under state law. Here was a provisional bridge to a new way of seeing board governance, consistent with our informational governance proposal, and yet the path remained uncertain due to the liminal procedural setting of the decision.

[50] *Caremark* at __.

[51] For a comprehensive review of the development of the case law, emphasizing the "political salience" of the scope of director liability, see Leo E. Strine, Jr., Lawrence A. Hamermesh, R. Franklin Balotti, & Jeffrey M. Gorris, *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L. J. 629 (2010).

[52] DGCL § 102(b)(7).

exculpation, the decision continued for years to confound commentators and counsellors. A decade passed before the Delaware Supreme Court affirmed the existence of *Caremark* duties for directors. By that time, information technology had vastly altered what was possible in terms of directors' governance of internal controls and their import for board leadership in corporate information and communications governance, as is discussed in Part II.

4. Passive Institutional Investment

Within the agency-cost framework, corporate governance cohered around two master theories, both targeted at maximizing shareholder wealth. The principle of *board primacy*—wherein boards operate as surveilling surrogates for dispersed, passive shareholders—was described above. Its counterpoint is the school of *shareholder primacy*—wherein shareholders seek more directly to intervene in corporate affairs in their interest. Changes in the capital markets and in information and communication technology have made it less expensive and more convenient for shareholders to act collectively to pursue corporate profit maximization. The past forty years have witnessed a transformation towards concentrated stock ownership by institutions:[53] mutual funds, public and private pension funds, trusts and endowments, insurance firms and most salient recently, hedge funds. As a result of these changes, legal commentators wondered aloud whether institutional investors would resolve the agency-cost problems that accompanied separating ownership from control.[54]

Somewhat surprisingly, back in the 1990s it became clear that institutional block holders would rarely use the proxy process, much less the threat of hostile tender offer, to intervene in corporate affairs.[55] Active institutional investor ownership failed to materialize. This was the result of many factors: the chilling structure of federal proxy

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[53] For a quantitative profile of the types of institutional owners and assets under management (including projections), see Pricewaterhouse Coopers, Asset Management 2020 A Brave New World, at https://www.pwc.com/gx/en/asset-management/publications/pdfs/pwc-asset-management-2020-a-brave-new-world-final.pdf. For analysis of the U.S. legal and regulatory framework accompanying intensive capital market concentration, see Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267 (2016).

[54] *See, e.g.*, Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895 (1992); Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor,* 91 COLUM. L. REV. 1277 (1991); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L. J. 445, 449-51 (1991).

[55] For discussion of the passivity, see, e.g., John C. Coffee, Jr. *Liquidity Versus Control: The Institutional Investor as Corporate Monitor.*, 91 COLUM. L. REV. 1277; Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L. J. 445 (1991).

regulation, the *in terrorem* effect of SEC rule 13D, costs of collective action (i.e., bearing all costs while sharing gains), fund managers' compensation structure, and asset managers' incentivize not to alienate incumbent managers. The agency costs of agency capitalism produced inertia in this period. [56]

But this too began to change in the 2000s, especially after the financial crisis generated greater calls for accountability to shareholders. The SEC initiated a project of shareholder proxy access in the years after Dodd Frank.[57] The basic idea was to enable certain large block holders to propose a short slate of director nominees for a vote based on a unitary, company proxy statement.[58] But intense controversies and roadblocks ensued from the SEC's proposals, and shareholder nominees in the company proxy did not become a meaningful possibility until quite recently, and via a different regulatory route.

5. Activist Hedge Funds and the Proxy

Back in the 1980s, the advent of bust-up takeovers had raised bedrock issues about the future and legitimacy of board primacy.[59] Would boards be freed, under the business judgment rule, to fend off in-the-money bids for control—to just continue pursuing the strategy they had set *ex ante*? Regulation (especially control share acquisition statutes) and private ordering (especially poison pills and staggered boards) evolved, quickly, to dampen the then-immediate threat of shareholder primacy via hostile tender offers.[60]

Beginning in the mid-2000s, capital market conditions changed once again to favor an insurgent shareholder primacy movement with activist hedge funds in the vanguard. The route is a proxy-based threat

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[56] There were exceptions. In the Private Securities Litigation Act, Congress sought to leverage the clout of the largest institutional investors to monitor the agency costs attendant to private securities lawsuits. But institutions did not welcome vigorous participation as lead investors. *See, e.g.*, Stephen J. Choi & Robert B. Thompson, *Securities Litigation and Its Lawyers: Changes During the First Decade After the PSLRA*, 106 COLUM. L. REV. 1489, 1529 (2006) (questioning whether the lead plaintiff provision really encourages greater monitoring of plaintiff law firms).

[57] Dodd-Frank Act, § 971, 124 Stat. at 1915 (codified as amended at 15 U.S.C. § 78n (2006)). Congress did not specifically mandate proxy access, but rather authorized the SEC to adopt a proxy access rule.

[58] For citations and discussion, see Marcel Kahan & Edward Rock, *The Insignificance of Proxy Access*, 97 VA. L. REV. 1347 (2011).

[59] John C. Coffee, *The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders and Bust Ups*, 1988 WIS. L. REV. 435 (1988) (arguing for consideration of stakeholder interests by boards when evaluating takeover proposals).

[60] For discussion of the market and regulatory milieu, see Jeffrey N. Gordon, *Corporations, Markets and Courts*, 91 COLUM. L. REV. 1931 (1991). David K. Millon, *New Directions In Corporate Law Communitarians, Contractarians, And The Crisis In Corporate Law,* 50 WASH. & LEE L. REV. 1373 (1993)

that forces management to the negotiating table. The proxy access movement helped shift power to shareholders, placing boards under enormous pressure—since board assent remains a legal condition to fundamental corporate change. By attacking the status quo as sub-optimally lucrative, the activist hedge funds are presenting a highly destabilizing force in contemporary governance—especially where they succeed in enlisting support from ordinary institutional investors.[61]

The legal, policy, and technological environment is favoring activists' demands for change at the managerial level, in a comparison to the relative disfavor and burdens associated with 1980s corporate "raiders" and LBOs.[62] For example, many public companies have repealed their poison pills and staggered board defenses.[63] A vocal shareholder rights project at Harvard Law School is pressing the case against board primacy, and facilitating reforms in the direction of shareholder primacy.[64] The financial crisis increased investors' mistrust in board-centric governance,[65] and created support for law reforms

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[61] For discussion of the likely deleterious effects of activist campaigns, see, e.g., John C. Coffee, Jr., *The Wolf at the Door: the Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545 (2016), Leo E. Strine Jr., *Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System*, 126 YALE L. J. 1870 (2017); *but see* Bernard S. Scharfman, *Activist Hedge Funds in a World of Board Independence: Creators or Destroyers of Long-Term Value?* 2015 COLUM. BUS. L. REV. 813 (2015).

[62] While there are powerful dissents, there is a burgeoning literature documenting the positive shareholder wealth effects from activist campaigns. *See* Alon Brav, Wei Jiang, Frank Partnoy, & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729 (2008); April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN. 187, 213 (2009); Nicole M. Boyson & Robert M. Mooradian, *Corporate Governance and Hedge Fund Activism,* 14 REV. DERIVATIVES RES. 169 (2011); Christopher P. Clifford, *Value Creation or Destruction? Hedge Funds as Shareholder Activists*, 14 J. CORP. FIN. 323 (2008); Robin M. Greenwood & Michael Schor, *Investor Activism and Takeovers*, 92 J. FIN. ECON. 362 (2009); Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism* (Columbia Bus. Sch. Research Paper No. 13-66, 2013), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2291577; C. N. V. Krishnan, Frank Partnoy, & Randall S. Thomas, *Top Hedge Funds and Shareholder Activism* (2015), available at http://ssrn.com/abstract=2589992 or http://dx.doi.org/10.2139/ssrn.2589992; *see also*, Shane Goodwin, *Myopic Investor Myth Debunked: The Long-term Efficacy of Hedge Fund Activism in the Boardroom*, at 11-12 (2015), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2450214.

[63] Steven Davidoff Solomon, *The Case Against Staggered Boards*, N.Y. TIMES, March 20, 2012.

[64] While highly successful, the program is a lightning rod for governance controversy. *See, e.g.*, Andrew Ross Sorkin, *An Unusual Boardroom Battle, in Academia*, N.Y. TIMES, January 5, 2015; Lucian A. Bebchuk, *The Myth that Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637, 1638–39 (2013).

[65] For a candid scholarly treatment that faces the fundamental questions, see Jeffrey N. Gordon, *Is Corporate Governance First Order Cause of the Current Malaise?* (9/16/18 Draft paper on file with the authors).

promoting greater direct shareholder control.[66] The activists are exceptionally well positioned to make headway where they act in concert with one another and, also, if they gain support from the erstwhile more passive traditional, institutional investors.[67]

Before the financial crisis, the conceptual linkage between shareholder wealth maximization and enhanced social welfare mostly held. The changes triggered by Sarbanes-Oxley were regarded by elites as intrusive, disruptive—mostly administrative make-work for boards and their advisers.[68] Such "administrative" board governance swelled up from various hard and soft law sources. New rules and standards for board and committee conduct poured out of Congress, the SEC, the PCAOB, New York Stock Exchange and NASDAQ ("SROs") listing manuals, and an avalanche of industry guides. They covered committee and board work relating to auditing and financial reporting, CEO compensation and employee morale, and expanded social disclosure and investor interest in it, for example. Remarkably, the changes had had little impact on the broad conceptual framework of agency-cost board governance which continued to shape the conduct not only of shareholders, managers and directors themselves, but also investment bankers, corporate lawyers and legal academics, the SEC and Delaware's corporate judiciary. Until quite recently, despite the turmoil, the extensive population of corporate governance actors have held to their established views about corporate purpose (to enhance shareholder wealth) and board purpose (to limit managerial self-dealing and indolence).

Nevertheless, the "administrative" governance described above has compelled boards to become far more active and knowledgeable about corporate affairs. Surveys attest to the substantial increase in time they are spending on board work, and their deeper awareness of the emerging, pertinent issues. Legal advisers and management consultants, especially, mobilized to support boards'

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[66] Elisse B. Walter, *Speech by SEC Commissioner: "Restoring Investor Trust through Corporate Governance" — Remarks Before the Practicing Law Institute*, https://www.sec.gov/news/speech/2009/spch021809ebw.htm. For a comprehensive treatment of the issues, see STEPHEN M. BAINBRIDGE, CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS (Oxford 2012).

[67] Bernard S. Sharfman, *What Theory and the Empirical Evidence Tells Us About Proxy Access*, 13 J. L. ECON. & POL'Y (2017). In most circumstances, to succeed via the proxy (rather than informal pressure) route, the activists require the traditional institutional owners support for their proposals. For a treatment of activists' synergy with traditional institutional investors, see Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism, Activist Investors and the Revaluation of Governance Rights.* 113 COLUM. L. REV. 863, 875 (2013).

[68] For an unusual, sanguine view of Sarbanes-Oxley's intervention in corporate governance, see Jonathan R. Macey, *A Pox on Both Your Houses: Enron, Sarbanes-Oxley and the Debate Concerning the Relative Efficacy of Mandatory Versus Enabling Rules*, 81 WASH. U. L. Q. 329 (2003).

more intense engagement. Nevertheless, at the same time, activist hedge funds are demonstrating staying power in influencing corporate affairs. Gone is the "safe distance" between plenary board governance and shareholders' demands for large cash payouts. With the inexpensive means to leverage the proxy to demand radical strategic change, activists are destabilizing the status quo of board primacy. At the very least, their insurgency poses an important question: what is the value of the monitoring board?

6. Monitoring Boards Fail the Strategy Test

Because corporate law prevents shareholders—even activist hedge funds—from forcing fundamental corporate change without board assent, their rising influence in corporate affairs sets the stage for confrontation. How should boards judge whether to assent to activists vaunting a more profitable plan for the firm compared to incumbent managers'? Even focusing on profitability alone, in this crucial, high profile area of governance conflict, reliance on market forces—the lens of agency-cost governance—cannot solve the directors' problem. The uptick in trading price attendant to the activists' arrival may reflect the likelihood of a short-term payout, in essence a liquidation of greater future value at the expense of long-term value creation. Will the board be conversant in confidential information germane to the CEO's long-term value creation plan? Is the market unable to decipher corporate plans which are genuinely wealth generating? Aside from reliance on stock price signals, agency-cost governance does not prepare directors to understand, analyze, or communicate about how or why the CEO's plan is (or is not) more valuable than the plan proposed by activists.

Market studies do not resolve the issue about the wealth effects of activists' interventions. An uptick in the stock's immediate trading price is not a reliable indicia of superiority where time horizons are taken into account. No reliable market-based measure exists for boards to distinguish genuinely value-creating business reforms from overall value-destroying ones. Alongside a sophisticated empirical literature attesting to genuine wealth creation from activists' interventions exists an equally expert empirical literature suggesting value destruction.[69]

[69] For treatments presenting empirical data skeptical of activists' value-creation claims, see, e.g., Lynne L. Dallas, *Short-Termism, the Financial Crisis, and Corporate Governance*, 37 J. CORP. L. 265, 268 (2011); Cremers, Masconale, & Sepe, *Activist Hedge Funds and the Corporation*, 94 WASH. U. L. REV. 261 (2016); John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 IOWA J. CORP. L. 545; Leo E. Strine, Jr. *Who Bleeds When the Wolves Bite?: A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate*

This is the crucible that boards face in the current capital market climate, especially because faith in stock prices is not what it once was.[70]

The case for aberrations or inefficiencies in capital market prices—"short-termism" and "bubbles," for example—has become compelling after the global financial crisis.[71] Being thinly informed about its firm's strategy, a board may simply capitulate. Directors may have too little information about strategic initiatives contemplated by management. Or they may be ill-acquainted with the risks and prospects of the strategy underway.[72] Nor is a philosophy of "just say no" inherently better. In the absence of a deep understanding of strategy and the firm's status in its competitive environment, the board is vulnerable to status quo bias—as behavioral finance suggests is often true.

This is the shareholder-profit-oriented Achilles heel of the monitoring board. If directors cannot comfortably rely on stock prices as a benchmarks of corporate performance, the monitoring board fails on its own profit-maximization terms. Its narrow focus on limiting managerial waste makes it unreliable as a medium of shareholder value. In sum, directors in the monitoring model are poorly equipped to assess the merits of their firm's strategy. Nor have they been encouraged to ask other critical questions germane to corporate value—such as whether the firm's culture and reputation are being cultivated to create employee and customer loyalty and shareholder confidence in risk management and legal compliance. Even if they serve on the audit committee, it is unlikely they have leveraged the crucial financial and operating information they learned to evaluate management's strategic plans. Under the monitoring model, directors aren't supported in translating risk management and legal compliance

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Governance System, 126 YALE L. J. 1870 (2017). For scholarship embracing the net-value creation version of activists' interventions, and rejecting the short-termism thesis, see Bebchuk, Brav, & Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085 (2015); Kahan & Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021; Gilson & Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Reevaluation of Governance Rights,* 113 COLUM. L. REV. 863 (2013). For studies suggesting strong boards are key to withstanding improper, value-negating activist campaigns, see, e.g., Bernard S. Sharfman, *Activist Hedge Funds in a World of Board Independence: Creators or Destroyers of Long-Term Value*? 2015 COLUM. BUS. L. REV. 813 (2015); Dionysia Katelouzou, *Myths and Realities of Hedge Fund Activism: Some Empirical Envidence*, 7 VA. L. & BUS. REV. 459 (2013).

[70] 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).

[71] *See* William W. Bratton & Michael L. Wachter, *The Case against Shareholder Empowerment*, 158 U. PA. L. REV. 653 (2010).

[72] Ronald J. Gilson & Jeffrey N. Gordon, *Boards 3.0: An Introduction*, 74 BUS. LAW. 351 (2019) (conceding the problem of agency cost boards' relative ignorance about strategy and arguing in favor of a board strategy committee).

knowledge gained in committee to the construction of a solid ESG profile at the board level. Monitoring boards don't seek these connections or capitalize on the opportunities their committee experience affords them. A new model of board governance—the CIF model—is required to address these lost opportunities.

B. The End of "Separate Realms" Thinking

For much of the last quarter of the twentieth century, "separate realms" thinking supported the agency-cost approach. The separate realms conceit allowed managers to relegate "social" or "nonfinancial" information and activity to a second-class, nonbusiness category. With corporate law ignoring the social ramifications of business leadership (including vastly increased inequality), boards and officers were free to manage companies exclusively for stock price maximization. In the last two decades, however, the separate realms approach has been debunked.[73] Not only has it become clear that investors and other groups have great interest in firms' ESG performance and risks, but companies' own headlong rush into the political sphere has undermined any notion that corporations are apolitical.[74] As a result, we see an upsurge in demands for boards to create information systems to manage ESG risks, to supervise reliable, clear ESG disclosures (mandatory and voluntary), and take responsibility for creating and sustaining an ethical firm culture encompassing ESG concerns.

1. The Demise of Technocratic Business Governance

Like the agency-cost paradigm, the "separate realms" concept has been pervasive yet elusive in corporate governance.[75] Dating from the late 1970s, it arose amidst backlash against anti-war and civil rights protests, and fears which the progressive, Great Society political movement had catalyzed among elites.[76] The academic, policy and public intellectual environment which rationalized "business friendly," technocratic thinking allowed it to be nearly hegemonic in its influence

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[73] *See, e.g.*, Sarah E. Light, *The Law of the Corporation as Environmental Law*, 71 STAN. L. REV. 137 (2019). For a recent overview of cutting-edge heterodox economic research, see HEATHER BOUSHEY, UNBOUND: HOW INEQUALITY CONSTRICTS OUR ECONOMY AND WHAT WE CAN DO ABOUT IT (2019).

[74] For an unabashed treatment of the companies' strategic imperative to engage the legal and regulatory process proactively, see Constance E. Bagley, *What's Law Got to do with It?: Integrating Law and Strategy*, 47 AM. BUS. L. J. 587 (2010).

[75] For a treatment of the deep ideational substructures of separate realms concepts as they influenced law in this period, see generally, Chen and Hanson, *The Illusion Of Law: The Legitimating Schemas Of Modern Policy And Corporate Law*, 103 MICH. L. REV. 1 (2004).

[76] For an account of the clashes in this period, see generally, Sarah C. Haan, *Civil Rights and Shareholder Activism: SEC v. Medical Committee for Human Rights* 76 WASH & LEE L. REV. 1167 (2019).

and authority.[77] In essence, Milton Friedman's famous essay in the *New York Times Magazine* stated what became the guiding principle of corporate governance throughout this period: that "there is one and only one social responsibility of business, to use its resources and engage in activities designed to increase its profits."[78] The admonition was thrilling—an easy sell—on account of its totalizing simplicity.

Beginning in the 1980s, business schools in the U.S. became enmeshed with university economic departments, which helped foster the neoclassical economic laser focus on corporate profit maximization. Falling in line, legal academics pilloried commentators working outside the agency cost paradigm—especially those concerned with businesses' "social responsibilities." The recalcitrant strands of progressive corporate law scholarship that persisted were disparaged by elite scholars as jejune. The economic wisdom of the time openly stated that "inequality did not matter," only growth—and growth did not take into account effects on climate change and environmental resources. The foundational structures of university education, and especially the academic silos separating economics from history (or, for that matter, international relations, law, and programs in public policy) prevented consideration of the social and environmental impacts of corporate-based globalization, beyond reductionist concepts of "externalities."

Implicit in the structure of the federal proxy shareholder proposal rules, and express in the SEC'S rationales for enabling exclusion of pro-social shareholder proposals, was the view that business affairs are apolitical, *a priori*, and should remain so—untainted by exogenous, "political" demands of corporate gadflies. Analogously, the dominant corporate case law relied on uncertain precedent to denominate shareholders "owners" of corporate property.[79] Moreover, it enabled the masking of socially salient business affairs via the "business judgment rule" (or "BJR"). By operating as a judicial rule of abstention, the BJR prevented judicial consideration and judicial notice of socially responsible business conduct "on the ground," and the legitimate scope of corporate managers' discretion to pursue long term business goals, such as investing in employees, communities and other ESG matters. In place of affirming boards' legitimate authority to weigh multi-stakeholder demands and progressive social values, the

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[77] In the years after the financial crisis several superb accounts of the intellectual sovereignty of corporate neoliberalism have issued. *See, e.g.*, COLIN CROUCH, THE STRANGE NON-DEATH OF NEOLIBERALISM (2011).

[78] Milton Friedman, *A Friedman Doctrine - The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970, 6 (Magazine), at 33.

[79] Dodge v. Ford Motor Co., 204 Mich. 459 (1919).

silence emanating from these texts and authoritative bodies fostered the legal embrace of shareholder wealth maximization.

With the law ignoring the social dimensions and ramifications of business leadership, boards and officers were encouraged to manage companies exclusively for stock price maximization in the interest of shareholders. Where employees, or the environment, or fair commercial practices, or enhanced product safety, or supply chain management issues, or even shareholders' actual preferences other than immediate profit maximization might have been relevant to boards' and executives' choices boards had legal freedom to chart their own course. But the powerfully influential mainstream view was that so long as companies were not breaking the law, profit-making for shareholders resolved the matter. Reviewing these constructs in retrospect, their formative ideological biases and limits appear obvious in a way they were not open for conversation, or serious research, at the time.

As pressing macro-social problems become more visible in firms' operating choices, a critical transformation is occurring in corporate affairs. Gone is the neutral trope of technocratic business management as a bulwark of corporate capitalism and social welfare.[80] Even the business-led push to deregulate, ironically, has led to greater pressure on individual companies to decide where they will draw the line on exploiting their bargaining power and informational advantages. The broad scope of legally permissible but ethically questionable business conduct has created immense reputational risks for firms, boards and CEOs. For example, publicity over gruesome conditions in supply chains has reached back to tarnish the reputations of legally distinct corporate parents and vendors.[81] Accordingly, contemporary corporate governance is increasingly rejecting the formerly conventional, rigid "financial" versus "non-financial" categories for business management and investor concern. Media outlets and corporate stakeholders, rightly, are unconcerned with ascribing unethical, reputation-destroying conduct to one formal category or the other.

What is emerging is a new global governance regime in which both corporate stakeholders and the wider public expect firms to

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[80] Even leaders in mainstream governance are reckoning with the obvious shortcomings of the traditional model. *See, e.g.,* Leo E. Strine, Jr., *Toward Fair and Sustainable Capitalism: A Comprehensive Proposal to Help American Workers, Restore Fair Gainsharing between Employees and Shareholders, and Increase American Competitiveness by Reorienting Our Corporate Governance System Toward Sustainable Long-Term Growth and Encouraging Investments in America's Future*, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3461924.

[81] See *id.*

cultivate and observe ethical values and standards in their affairs, irrespective of whether those values and standards are mandatory under law.[82] These values and standards include diversity and inclusion, honesty and transparency, respect for human rights, dedication to product safety, and consideration of environmental sustainability. The "G" in governance presumes that some deliberative body in the firm—rightly the board—will be paying attention to these matters and exercising leadership on a case by case basis, consistent with the firm's thriving. In this respect, the dialogue has shifted from ensuring (minimal) compliance to engaging proactively in the management of corporate reputation as a vital resource. In response to these pressures, the role of boards continues to expand and directors' responsibilities deepen.[83]

2. Stakeholders Care About ESG

The global ESG movement has swept across the U.S. investment scene. An avalanche of evidence suggests that institutional and retail investors, as well as other stakeholders, care a great deal about environmental, social, and governance policies at U.S. firms, and will follow up their interest with action. The rise of ESG activism is well-documented. Once dismissed as eccentrics, ESG investors now hold trillions of dollars of invested capital, and a growing proportion of new investor funds are directed toward ESG investments.[84] In 2016, roughly a quarter of assets under management in Asia, Australia and New Zealand, Canada, Europe, and the U.S. were ESG investments.[85] In the first five months of 2018, sustainable investment funds averaged $924 million in monthly inflows, nearly double the monthly average in 2017.[86] Though these numbers reveal enormous investor interest in sustainable investment funds, they tell only part of the story. For example, ESG concerns are influencing debt investment,

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[82] For a rigorous examination of global governance issues in the context of networks of supply chains, see Virginia Harper Ho, *Team Production and the Multinational Enterprise*, 38 SEATTLE U. L. REV. 499 (2015).

[83] For a scholarly treatment of corporate boards' responsibilities and opportunities in promoting diversity, from the perspective of Canadian corporate governance, see Aaron A. Dhir, *Towards a Race and Gender-Conscious Conception of the Firm: Canadian Corporate Governance, Law and Diversity*, 35 QUEEN'S L.J. 569 (2010).

[84] *See* Georg Kell, The Remarkable Rise of ESG, FORBES, July 11, 2018, available at: https://www.forbes.com/sites/georgkell/2018/07/11/the-remarkable-rise-of-esg/#2791d7021695.

[85] Sara Bernow, From 'Why' to 'Why Not': Sustainable Investing as the New Normal, McKinsey.com, October 2017, available at: https://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/from-why-to-why-not-sustainable-investing-as-the-new-normal. The percentage in the U.S. was slightly lower, at 21.6 percent. *See id.*

[86] Jon Hale, *5 Things About Sustainable Investing in the First Half of 2018*, Medium.com, July 6, 2018, available at: https://medium.com/the-esg-advisor/5-things-about-sustainable-investing-in-the-first-half-of-2018-4f8230709a58.

as well as equity.[87] Moody's, the credit rating agency, has spent the last three years increasing its incorporation of ESG metrics into its credit ratings, and its competitors are likewise factoring ESG risk into their metrics.[88] In the same period, even traditional institutional investors have stepped up their focus on ESG—as just one example, BlackRock has created new index products to allow ESG tailoring of index investments[89]—and are demanding more ESG engagement by boards.[90] As proxy advisory services are becoming ESG advocates, they too are increasing the voting power and visibility of ESG activism.[91] Institutional Shareholder Services now includes environmental and social scores alongside governance scores in the company-specific reports that it sends to subscribers.[92] Glass Lewis, the major business consulting firms and even the Business Roundtable are becoming similarly committed to enhanced ESG stewardship.

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[87] *See, e.g.*, Stephen Kim Park, *Investors as Regulators: Green Bonds and the Governance Challenges of the Sustainable Finance Revolution*, 54 STAN. J. INT'L L. 1, 4 (2018) (noting that the green bond market "has grown dramatically since 2013"); Matt Wirz, Social Investing Has New Message: Bond Managers See It As a Crucial Ingredient of Risk, WALL ST. J., June 20, 2018 (describing a "frenzy to adopt ESG" in the bond markets).

[88] *See, e.g.*, Moody's Investors Service Press Release, Moody's Hires Carbon and Corporate Governance Experts to Join its ESG Team, February 28, 2018; Moody's Investors Service Press Release, Moody's Appoints Rahul Ghosh to Deepen Work on Impact of ESG Factors in Credit Ratings, November 1, 2017 (Moody's is "seeking to deepen its commitment to assessing the impact of Environmental, Social and Governance (ESG) considerations in its credit ratings"); Moody's Investors Service Press Release, Moody's Ratings Incorporate ESG Considerations with Material Credit Implications, October 25, 2017 ("Moody's Investors Service continues to strengthen its commitment to its assessment of [ESG] considerations and how they impact different sectors and debt issuers").

[89] *See, e.g.,* Rob Cox, Why BlackRock's Move to Disarm Some Funds Is Good Business, N.Y. TIMES, April 6, 2018 (describing how BlackRock has created new index funds that exclude firearms manufacturers and sellers).

[90] https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter (Letter from Larry Fink to CEOs, requesting that "directors assume deeper involvement with a firm's long-term approach"); *see also* New York City Pension Funds, "Best Practices" in Board Matrices, August 2018, available at: https://comptroller.nyc.gov/wp-content/uploads/2018/08/NYC-Comptrollers-Office-Matrices-Compendium-8-2018-FINAL.pdf. (NYC pension funds' Boardroom Accountability Project advocating that corporations publish board matrices with information about directors' race, gender, and sexual orientation).

[91] For example, Glass Lewis has announced that, beginning in 2019, it will recommend voting against the chair of a company's nominating committee if the company's board has no women members. Glass Lewis, 2018 Proxy Guidelines, United States, at 22-23, available at: http://www.glasslewis.com/wp-content/uploads/2018/01/2018_Guidelines_UNITED_STATES.pdf.

[92] Institutional Shareholder Services, ISS QualityScore: Environmental & Social Disclosure QualityScore FAQ, October 2018, at 8, available at: https://www.issgovernance.com/file/faq/Environmental-Social-QualityScore-FAQ.pdf (noting three "Environmental Pillar" categories: Management of Environmental Risks and Opportunities Carbon & climate; Waste & Toxicity; and Natural Resources; and four "Social Pillar" categories: Product Safety, Quality & Brand; Stakeholders & Society; Labor Health & Safety; and Human Rights).

Indeed, a small industry has emerged to rate companies' success in managing the pressing moral, social and operational challenges scrutinized by shareholders, employees[93] and consumers[94] under the rubric of ESG. Increased interest in ESG is being expressed through activists' public relations campaigns, stakeholders' contacts with companies' Investor Relations departments, shareholder proposals, industry surveys, institutional investor mission statements and reports and companies' own websites and publications.

As investors track the ethical, moral and environmental conduct of firms, they are also tracking risks that may, perhaps instantaneously, become pressing financial problems because they influence investors', employees', and consumers' choices in real time.[95] ESG metrics provide a measures of risk management quality, and hence a lens through which to assess the quality of the board's leadership in creating the informational and institutional infrastructure of long-term corporate value creation.[96] In this vein, the scope of material risks facing companies has broadened significantly in just the last decade. Recent examples include the rise of cybersecurity risks,[97]

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[93] There is an increasing body of sociological data documenting the connection between worker morale, productivity, and firm value—and morale's relation to ethical and mission-driven cultures. *See, e.g.*, Dallan F. Flake, *Bearing Burdens: Religious Accommodations That Adversely Affect Coworker Morale*, 76 OHIO ST. L. J. 169 (2015).

[94] For an overview of the many CSR/ESG rating outfits, see Davis Polk, *Client Memorandum: ESG Reports and Ratings: What they Are, Why they Matter?* July 12, 2017 ("Most international and domestic public (and many private) companies are being evaluated and rated on their environmental, social and governance (ESG) performance by various third party providers of reports and ratings."), available at https://www.davispolk.com/files/2017-07-12_esg_reports_ratings_what_they_are_why_they_matter_0.pdf. For commentary on improving the ratings system, see, e.g., Thuy-Nga T. Vo, *Rating Management Behavior and Ethics: A Proposal to Upgrade the Corporate Governance Rating Criteria*, 34 IOWA J. CORP. L. 1 (2008)1.

[95] *See, e.g.*, Virginia Harper Ho, *Risk-Related Activism: The Business Case for Monitoring Nonfinancial Risk*, 41, J. CORP. L. 647 (2016); Why Companies Must Manage Environmental, Social and Governance Risks, Wharton Social Impact Podcast, October 17, 2018, (discussion among Witold Henisz, Katherine Klein, and Sherryl Kuhlman), available at: http://knowledge.wharton.upenn.edu/article/companies-need-manage-environmental-social-governance-risks/ (Professor Henisz using the term "non-traditional risks" to describe "risks that emanate from the social sector and from the external stakeholders around them, whether they be community leaders, NGOs, or government officials who are upset or concerned about pollution, human rights and social rights").

[96] For a review of the fiduciary underpinning of such board duties, see, e.g., Eric J. Pan *A Board's Duty to Monitor*, 54 N.Y.L. SCH. L. REV. 717 (2009).

[97] *See* Mayer Brown 2019 Proxy and Annual Reporting Season: Let the Preparations Begin, September 17, 2018, available at: https://www.mayerbrown.com/files/Publication/e6cedd0b-c795-49ab-bd0b-4bdb7930d157/Presentation/PublicationAttachment/9175842f-d8c1-4046-a23e-5fb8c1d62c82/proxy-reporting.pdf ("cybersecurity is recognized as a pervasive issue that impacts companies of all types, generating risks from both an economic and

the opioid crisis,[98] risks associated with the #metoo movement,[99] stakeholders' responses to firms' and CEOs' political activities, and corporate responses to racist statements or behaviors.[100] Some ESG matters, such as climate risk, present direct current and future material risks to companies' strategic direction and operational performance—at which point they are, of course, not "nonfinancial." A seemingly amorphous matter like the cultivation of an ethical leadership culture (conventionally described as "tone at the top"), might initially appear supernumerary—exogeneous to the essential commercial work to be done by management. But disasters of the kind that, for example, occurred at Enron (corporate fraud), WorldCom (corporate fraud), Volkswagen (the emissions scandal), AIG (described by Judge Leo Strine in a 2009 decision as a "criminal enterprise")[101] and Boeing (deafness to internal safety warnings) demonstrate otherwise.[102] These individual corporate mishaps attest to the challenge and urgency of establishing ethical infrastructures atop sprawling, global, decentralized business enterprises.[103] In this regard, ESG is, in part, a "soft law" modality for addressing the trenchant problems produced by amorphous, globalized supply chains in international business firms. The magnitude of these problems and their impact on

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security perspective"); SEC Commission Statement and Guidance on Public Company Cybersecurity Disclosures, February 26, 2018, 17 CFR 229 and 249, available at: https://www.sec.gov/rules/interp/2018/33-10459.pdf.

[98] Several institutional investors banded together in 2017 to create Investors for Opioid Accountability, which has focused on activism at opioid manufacturers and distributors, and at companies that manufacture treatments for opioid abuse. *See* Proxy Preview 2018 at 48-49. During the 2018 proxy season, AmerisourceBergen published two shareholder proposals related to its opioid crisis risk in its Proxy Statement; both major proxy advisory firms, ISS and Glass Lewis, supported the proposals. *See* Investors for Opioid Accountability Press Release, ISS, Glass Lewis Support Investors for Three Opioid Accountability Shareholder Proposals at AmerisourceBergen, February 14, 2018, available at: https://ucfunds.org/wp-content/uploads/2018/02/IOA-Statement-on-ISS-and-Glass-Lewis-Support-for-AmerisourceBergen-Shareholder-Proposals-FINAL-2-14-18.pdf. Both proposals won a majority of independent shareholder votes, though neither met the threshold for shareholder approval. *See* AmerisourceBergen Corporation 2018 Proxy Statement (Jan. 19, 2018) at 71-74 (Proposal 7) & 74-77 (Proposal 8); AmerisourceBergen Corporation Form 8-K (March 1, 2018) (reporting voting results).

[99] *See, e.g.,* David A. Katz and Laura A. McIntosh, Shareholder Activism Is the Next Phase of #MeToo, N.Y. L. J., September 26, 2018.

[100] Tonya Garcia, *Starbucks, ABC Responses To Racist Incidents Show Business Value Of Decisive Action*, Market Watch, June 4, 2018.

[101] 965 A.2d 763 (Del. Ch. 2009).

[102] For discussion of the board's role in establishing and implementing an ethical culture in business firms, see Lynne L. Dallas, *Enron and Ethical Corporate Climates*, in ENRON CORPORATE FIASCOS AND THEIR IMPLICATIONS (Nancy B. Rapoport & Bala G. Dharan eds., 2004).

[103] David Hess, *Ethical Infrastructures and Evidence-Based Corporate Compliance and Ethics Programs: Policy Implications from the Empirical Evidence*, 12 N.Y.U. J. L. & BUS. 317 (2016).

companies perforce enlists boards (as the senior-most legal authorities in corporations) in creating new policies and vehicles for leadership.

Of course, special criticism is being directed at technology companies, both in regard to their social and political impacts and failures to safeguard customers' personal information. These failures are materially affecting their stock prices and commanding board-level concern.[104] As an example, the Audit Committee at Facebook was informed, belatedly, by the company's head of security about Russian-linked activity on the social media company's network. The tardy revelation "prompted a humiliating boardroom interrogation" of the company's CEO and controlling shareholder, Mark Zuckerberg, and its COO, Sheryl Sandberg, along the lines of "what do you know and when did you know it?"[105] The Facebook story underscores that twenty-first-century boards expect to be actively informed about threats to corporate reputation—to the point of challenging the company's controlling shareholder in the above instance. Put simply, boards cannot afford to be, and should not accept being, blindsided by reputational risks and scandals. Instead of passive monitors surveilling managerial agency costs, boards are commanding governance upgrades in internal control systems, and elevated standards of candor, even if they make for difficult conversations in the boardroom.

3. Demands For ESG Information

[104] For a summary of data privacy scandals that affected Facebook's stock price in 2018—including a $36 billion loss of market cap after the Cambridge Analytica scandal became public in March—see Salvador Rodriguez, Here Are the Scandals and Other Incidents That Have Sent Facebook's Share Price Tanking in 2018, CNBC.com, November 20, 2018, at https://www.cnbc.com/2018/11/20/facebooks-scandals-in-2018-effect-on-stock.html; *see generally* James Grimmelman, *Saving Facebook*, 94 IOWA L. REV. 1137 (2009). Giant fines levied by European authorities under the GDPR have also caught boards' attention. *See, e.g.*, Adam Satariano, After a Data Breach, British Airways Faces a Record Fine, N.Y. TIMES, July 8, 2019 ($230 million fine); Adam Satariano, Google Is Fined $57 Million Under Europe's Data Privacy Law, N.Y. TIMES, Jan. 21, 2019.

[105] According to an investigation by the *New York Times*, the disclosures "set off [Erskine] Bowles," the Committee's chair, who "pelted questions" at Zuckerberg and Sandberg at a full board meeting later in the same day. *See* Sheera Frenkel, Nicholas Confessore, Cecilia Kang, Matthew Rosenberg and Jack Nicas, Delay, Deny and Deflect: How Facebook's Leaders Fought Through Crisis, N.Y. TIMES, November 14, 2018. According to the N.Y. Times investigation, Alex Stamos, Facebook's head of security, "acting on his own," led an investigation to uncover the scope of Russian activity on Facebook, then met with top officers of the company, including COO Sheryl Sandberg and Zuckerberg to report his findings. Publicly, company officials played down the role of Russian-linked groups before the 2016 election. "By August 2017, Facebook executives concluded that the situation had become what one called a 'five-alarm fire.'" *Id.*

Within the framework of the erstwhile narrowly financial S-K regulations (which define the scope of mandatory corporate periodic and event-driven reporting), the SEC is presently enabling certain social matters to enter the public domain and corporate consciousness via calendar reporting (10-Ks, 10Qs and the annual report to shareholders) and the shareholder proposal system. ESG proposals were often excludable from corporate proxies as matters not within the proper scope of shareholder power, or for touching on firms' ordinary business conduct and affairs.[106] SEC rule changes in the 1970s made a proposal excludable if it was not "significantly related" to a company's business.[107] These mind-numbingly opaque provision shut down many shareholder initiatives relevant to ESG, since they could neither be too immediately tied to nor extraneous to a company's business.

The number of ESG shareholder proposals submitted to U.S. public companies annually has nevertheless been on a slow upward climb.[108] Each proxy season in the U.S., shareholders now ordinarily submit more ESG proposals than traditional governance proposals.[109] Moreover, shares voted in support of ESG proposals have been steadily growing since at least 2000. That year, ESG proposals put to a vote averaged 7.6% shareholder support;[110] whereas in 2018, the average shareholder support was as high as 32.8%.[111] Ten ESG

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[106] The ordinary business exclusion was codified by the SEC in January 1954. *See* SEC Exchange Act Release No. 4979, Jan. 6, 1954, 19 Fed. Reg. 246 (1954).

[107] SEC Securities Exchange Act Release No. 9784 (September 22, 1972).

[108] Though reliable numbers are hard to come by, *Proxy Preview*, published annually by As You Sow, The Sustainable Investments Institute, and Proxy Impact, provides an annual count of ESG shareholder proposals submitted to U.S. public companies by February of proxy season. *Proxy Preview* counted 429 for the 2018 proxy season. *See* Proxy Preview 2018 at 13 (noting that "a dozen or so more [proposals] are likely to be filed for meetings that occur after June"). Compare this to 2006, when *Proxy Preview* counted 357 ESG shareholder proposals. *See* Proxy Preview 2015 at 11 (Proposals Filed, 2006-2015). Gibson Dunn, the law firm, has also published ESG proposal numbers; for 2018, it counted 202 "social" proposals, 139 environmental proposals, and 92 proposals related to corporate political engagement, for a total of 433. *See* Gibson Dunn, 2018 Proxy Season, supra note __. Gibson Dunn also identified 20 proposals that requested the use of social or environmental performance metrics to set executive compensation. *Id.* Including these in the count would bring the total to 453 for 2018.

[109] Gibson Dunn, 2018 Proxy Season, *supra* note 108 (in 2018, ESG proposals were the "most frequently submitted" type of proposal); *see also* Sarah C. Haan, Shareholder Proposal Settlements and the Private Ordering of Public Elections, 126 YALE L. J. 262, 301 (2016) (noting the submission of more ESG than governance proposals in 2014 and 2015).

[110] For a discussion of the evolution of shareholder support for ESG proposals, *see id.* at 294.

[111] Gibson Dunn, Shareholder Proposal Developments During the 2018 Proxy Season, July 12, 2018, available at: https://www.gibsondunn.com/wp-content/uploads/2018/07/shareholder-proposal-developments-during-the-2018-

shareholder proposals won a majority of independent shareholder support in the 2018 proxy season, a record high.[112]

ESG awareness is being pressed from the outside in, and also from the top of government. In the Dodd-Frank Act, Congress pushed the SEC to require substantially enhanced socially-relevant disclosures, and the SEC is no longer wedded to the view that socially significant matters are separable from traditional business ones. Indeed, in 2014, the Commission solicited public comments to its "Disclosure Effectiveness" initiative, which sought to evaluate and potentially reform corporate disclosures. Subsequently, the Commission issued its 2016 Concept Release on Business and Financial Disclosure Required by Regulation S-K ("Concept Release"), which sought input regarding expanded ESG reporting. In the face of massive interest in the subject, as evidenced by the outpouring of comment letters received, on October 1, 2018, law professors Cynthia Williams and Jill Fisch submitted a rulemaking petition to the SEC in favor of expanded ESG disclosure. The petition was signed by investors and associated organizations representing more than $5 trillion in assets under management.

The dual fronts of debt and equity have heightened the pressure on boards to make progress on corporate identity, and the SEC itself is demanding more of boards. In late 2017, the SEC issued guidance that encouraged a company seeking to exclude an ESG shareholder proposal to address include in its no-action request the *board's* analysis of the substance and significance of the policy issues raised.[113] The SEC's no-action response signaled its belief that boards

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proxy-season.pdf; *but see* ISS Analytics, A Preliminary Review of the 2018 US Proxy Season, July 20, 2018, at 6 (overall shareholder support for ESG proposals was 24% in 2018 proxy season).

[112] *See* Interfaith Center on Corporate Responsibility, Catalyzing Corporate Change, June 30, 2018, at 1, available at: https://www.iccr.org/sites/default/files/iccr_-_catalyzing_corporate_change_2018_073018.pdf (winning proposals took place among shareholders at Sturm Ruger (gun violence), AmerisourceBergen (2 proposals related to opioids) (majority of independent votes), Tyson (water) (majority of independent votes), Kinder Morgan (climate change), Genessee & Wyoming (climate change), Middleby (climate change), Anadarko Petroleum (climate change), Ameren (water/coal ash), and Range Resources (methane)). *See also* ISS Analytics, A Preliminary Review of the 2018 US Proxy Season, July 20, 2018, at 6 ("The number of majority-supported E&S resolutions rose over 2017 levels, from six to 10, tying the 2016 season for most majority-supported E&S proposals."); EY Center for Board Matters, 2018 Proxy Season Review, July 2018, at 4 (6% of ESG shareholder proposals that went to a vote won more than 50% of the vote).

[113] SEC Staff Legal Bulletin No. 141 (CF), November 1, 2017, available at: https://www.sec.gov/interps/legal/cfslb14i.htm (for exemptions under the "ordinary business" exception, Rule 14a-8(i)(7), "going forward, we would expect a company's no-action request to include a discussion that reflects the board's analysis of the particular policy issue raised and its significance"; for exemptions under the

should be actively involved in analyzing ESG policy reforms proposed by shareholders. After the 2018 proxy season, the SEC revisited the matter, providing additional color on its view that board level analysis adds value to no-action requests.[114] Although the second staff bulletin noted that board analysis is voluntary in no action requests, the clear implication is that board review of corporate exclusionary efforts is an important feature of governance, consistent with directors' fiduciary duties.

4. Law, ESG and the Political Corporation

Although Milton Friedman's 1970 essay acknowledged that business had to observe "the rules of the game," businesses were mobilizing, behind the scenes, to alter laws, regulations, and judicial standards of review in favor of unrestrained capital acquisition. This tactical mobilization was captured in Louis F. Powell, Jr.'s 1971 memorandum, which asserted that an "attack" on the American economic system required businesses to mobilize for political combat.[115] Then and now, this mobilization has taken place through the (nontransparent) funding of nonprofits and think tanks which, in turn, assumed influence in public policy. Corporate lobbying at the national level also became substantial beginning in this period. While initially reactive, corporate lobbyists soon became adept at influencing law and regulation in companies' interests.

Forty years ago, corporate political mobilization was largely invisible, but this is no longer true. Corporate political spending and CEOs' public political statements have become a serious reputational concern, attracting the attention not just of politicians but of journalists, watchdog organizations, investors, customers and

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"economic relevance" exception, Rule 14a-8(i)(5), "we would expect a company's Rule 14a-8(i)(5) no-action request to include a discussion that reflects the board's analysis of the proposal's significance to the company," and the "explanation would be most helpful if it detailed the specific processes employed by the board to ensure that its conclusions are well-informed and well-reasoned").

[114] SEC Staff Legal Bulletin No. 14J (CF), October 23, 2018, available at: https://www.sec.gov/corpfin/staff-legal-bulletin-14j-shareholder-proposals.

[115] Lewis F. Powell, Jr., Confidential Memorandum: Attack on American Free Enterprise System, Aug. 23, 1971, at 25-6, available at: https://scholarlycommons.law.wlu.edu/powellmemo/1/ ("Business must learn the lesson . . . that political power is necessary; that such power must be assiduously cultivated; and that when necessary, it must be used aggressively and with determination—without embarrassment and without the reluctance which has been so characteristic of American business."); s*ee also* Faith Stevelman Kahn, *Pandora's Box: Managerial Discretion and the Problem of Corporate Philanthropy*, 44 UCLA L. REV. 579, 653-57 (1997) (describing the politicized nonprofit organizations that receive corporate funds).

employees.[116] The resonance of concerns about corporate political activity are so great that, in one recent example, major companies rushed to claw back donations they had made to an incumbent U.S. Senate candidate from Mississippi after she was accused of making racist remarks.[117]

This Article's embrace of informational governance does not condemn or support corporate political activity, but rather affirms its inherent materiality and hence relevance to board governance. In the last two decades, and especially after *Citizens United v. FEC* was decided in 2010, there has been an increasing recognition that corporate political activity requires board-level oversight. Investor groups have waged a successful campaign demanding that boards of directors increase their supervision of political spending.[118] In 2016, the Business Roundtable formally endorsed board oversight of political spending.[119] Last year, 47% of S&P 500 companies employed some form of board oversight of political spending, with 35% assigning the review of trade association expenditures to a board-level committee.[120] *Citizens United* helped catalyze this change by significantly raising shareholders' interest in corporate political spending—a development that, many argued, made political spending qualitatively material and therefore "worthy of the board's attention."[121] Investor activism on corporate political spending is among the strongest categories of ESG

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[116] *See* Letter from Committee on Disclosure of Corporate Political Spending to Elizabeth M. Murphy, Secretary, U.S. Sec. & Exch. Comm'n (Aug. 3, 2011); Lucian A. Bebchuk & Robert J. Jackson, Jr., *Corporate Political Speech: Who Decides?* 124 HARV. L. REV. 83 (2010); John C. Coates, IV, *Corporate Speech & the First Amendment: History, Data, and Implications*, 30 CONST. COMM. 223 (2015). For a basic explanation of how businesses spend money to influence elections, illustrated with data from the 2012 federal election, see Sarah C. Haan, *Opaque Transparency: Outside Spending and Disclosure by Privately-Held Business Entities in 2012 and Beyond*, 82 U. CIN. L. REV. 1149, 1158-71 (2014).

[117] *See, e.g.*, Rachel Siegel, Walmart Wants Campaign Donation Back From Sen. Hyde-Smith After Her Support of Public Hangings, WASH. POST, Nov. 20, 2018 (Walmart, Boston Scientific, and Union Pacific demanded the return of their donations).

[118] The nonprofit Center for Political Accountability (CPA) made board oversight a core principle of a campaign it launched shortly after *Citizens United* came down. *See* Center for Political Accountability, The CPA Index of Corporate Political Accountability and Disclosure: How Leading Companies Navigate Political Spending in the Wake of Citizens United (October 28, 2011) at 6; *see also* Sarah C. Haan, *Shareholder Proposal Settlements and the Private Ordering of Public Elections*, 126 YALE L. J. 262, 275-76 (2016) (describing the CPA's campaign of shareholder activism).

[119] Business Roundtable, Principles of Corporate Governance (2016) at 28 ("To the extent that the company engages in political activities, the board should have oversight responsibility...").

[120] Center for Political Accountability, The 2019 CPA-Zicklin Index of Corporate Political Disclosure and Accountability (October 24, 2019) at 19, 27.

[121] The Conference Board, Corporate Political Spending (2d ed. 2015) at 14 ("Many make the case that the level of investor interest and reputational risk make the issue material, elevating the matter to the board level.").

activism, further focusing board attention on the company's spending and oversight systems.[122]

Moreover, the appetite for firms to take a stand in politics is growing. In the summer of 2019, 206 major corporations signed onto a U.S. Supreme Court amicus brief in a trio of cases contesting the relevance of LGBTQ rights to civil rights, anti-discrimination laws.[123] In another salient example, many CEOs who served on President Trump's business advisory council felt compelled to resign their positions after the President refused to denounce the Charlottesville white supremacist protesters in a timely and forceful fashion.[124] In October 2018, several CEOs who had planned to attend a conference in Saudi Arabia had to make rushed, high profile choices about whether to cancel, at the last moment, after the murder of Saudi journalist Jamal Kashoggi was credibly linked to Saudi Crown Prince Mohammed bin Salman. According to Andrew Ross Sorkin, writing in the *New York Times*, "businesses have faced perhaps their thorniest conundrum, caught between a global outcry, a vacuum of leadership from Washington and a country with a long memory."[125] These examples illuminate the intensity of attention and high stakes surrounding firms' and CEOs' political actions. This is activity which clearly exceeds "ordinary business" operations, the scope of discretion possessed by executive officers without need for board discussion and resolution.

The success that corporations have had in shaping public opinion through political spending have made it impossible to ignore the influence of corporations on public policy, law, and government. In the wake of *Citizens United*, there is a palpable resurgence of interest in observing the ways that corporate interests dominate political discourse and, possibly, outcomes.[126] If nothing else, corporate political activity since the 2010 Supreme Court decision in *Citizens United v. FEC* has made clear that firms have choices to make about how they will cultivate political influence and power. Widespread, national attention to the nature and influence of corporate political activity is certain to increase with the Presidential election cycle of 2020. Because directors can easily have an impromptu meeting using

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[122] *See* Haan, *Shareholder Proposal Settlements*, *supra* note 118, at 265 n.7 (proposals on corporate political spending constituted the largest category of ESG shareholder proposals in the 2016 proxy season); PROXY PREVIEW 5 (2019) (same for 2019).
[123] *Bostock v. Clayton County, Georgia.*
[124] *See, e.g.*, James B. Stewart, C.E.O.s Long Avoided Politics. Trump is Changing the Calculus, N.Y. TIMES, August 16, 2017 (noting that "boards were hastily meeting to map strategy," and "having ad hoc conference calls")
[125] Andrew Ross Sorkin, When Business Executives Become Reluctant Statesmen, N.Y. TIMES, October 16, 2018.
[126] 558 U.S. 310 (2010).

distance technology, it is legally and tactically difficult to justify why CEOs would make these salient choices, on their own behalf or on the firm's part, without obtaining the advice and consent of their boards.

Corporate law and governance did not traditionally attend to political action by firms or CEOs, even apart from the narrowed focus shaped by agency theory. Corporate law presumed that managers spent corporate funds in politics and philanthropy in the shareholders' interest.[127] There were few corporate law standards or cases of relevance governing firms', CEOs' or boards' decisions. With corporate law preoccupied by agency-cost concerns, inquiry into corporate politicking fell to other domains—election law, administrative law, or constitutional law. However, these other bodies of authority gave little focus to the particularistic shape of corporate-based activity.[128] Legal scholars are still playing catch-up to understand the ways that businesses shape and influence law, politics and the democratic process. As they do so, here again, business executives are positioned in the cross hairs of emerging awareness and opinion. The populist, anti-corporate backlash is universally felt, but newly emergent as a phenomenon that boards and officers are being asked more openly to address. What this means is that the political dimensions of corporate conduct, and the governance dimensions of CEO and corporate political action, are just now coming into fuller view as subjects of board governance.

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All the above discussion adds up to the conclusion that boards' duties are growing in scope and complexity—as the role of corporations in society grows in scope and complexity. Monitoring executive activity to limit agency costs is a thin, reductionist version of directors' duties in the governance of twenty-first-century firms. It does not even capture their full fiduciary or statutory duties. Making purely commercial decisions, constrained by competitive markets, to drive growth is a straw man—business, society and politics are inextricably linked, as is now universally apparent.

What the second paradigm shift demands of twenty-first-century boards is greater depth on ESG and political matters, not only to satisfy the investors and creditors who demand it, but to compete

[127] *See, e.g.*, A.P. Smith Manufacturing Co. v. Barlow, 13 N.J. 145 (1953) (corporate donation to Princeton University.)

[128] Here again, separate realms thinking encouraged an artificial intellectual divide, which is still mirrored in the conceit of "public law" (e.g. constitutional law, election law, anti-discrimination law) and "private law" (e.g. property, torts and corporate law).

for motivated employees and values-focused consumers. The scope and complexities of these corporate governance functions mean they cannot be passed off to the CEO to manage unilaterally, along with strategy and the rest. Consistent with law, professional standards and public demands, boards cannot confine themselves to narrowly delimited financial benchmarks in the nature of a standardized test. The best informed, capable firms, directors and CEOs will need to rely on and benefit from sophisticated information and communications resources developed and deployed under the board's stewardship.

II.

BEYOND THE MONITORING BOARD: INFORMATIONAL GOVERNANCE

Amidst the decline of the twin corporate governance paradigms of twentieth-century, a new paradigm has begun to emerge. In this Part II, we present informational governance as a superior model for public company governance. Informational governance intends the *active* mobilization of the firm's channels of data reporting, analysis, and communication, under the board's stewardship, extending throughout the organization, iteratively, in order to foster enterprise-salient self-knowledge and value for the firm. It is the product of board governance as communicative action. The new paradigm is being driven by expanded stakeholders' (including shareholders') demands, new information and communication technologies, and newly vigorous board engagement itself, especially at the committee level.

Board leadership in information gathering, analysis and communications should yield, over time, robust answers to the most vital corporate questions, including the following. What is our firm's source of competitive advantage? Is our corporate culture and reputation creating or destroying value? Are we, as a board, planning for escalating demands in ESG? Are we reporting results, and managing risk and legal compliance consistently and reliably? Are we, as a board, getting the candid and complete information we need to answer these questions? In forcing this dialogue at the top of the organization, and following up on the answers, board leadership constitutes communicative action. Boards aren't expected to answer these questions alone. To the contrary, informational governance is accomplished through the board's authoritative, strategic management of corporate knowledge and communications structures as catalysts for coherent collective action. Their challenge is to *lead* a coherent, collective process of informational governance.

In this Part, we explain how advances in information technology have created the predicate for this new board governance model. In particular, we present the audit committee as a case study in informational governance. Audit committees' work exemplifies the new level of board engagement in data gathering, knowledge formation and critical corporate communications and reporting. We show that audit committee leadership of the financial reporting process is neither *ad hoc* improvisation, nor reactive attentiveness triggered by warning signs. Post Sarbanes-Oxley, audit committees have been positioned, by a host of hard and soft law requirements to exert leadership in the financial reporting process. This has become a normalized audit committee duty that spans the annual reporting cycle. The heightened expectations attaching to audit committees' leadership in financial information gathering and reporting exemplify the new normal of robust board governance, which we describe as informational governance.

Either the audit committee itself or another committee of independent directors will also lead oversight of risk management and legal compliance. This Part also examines the board's newly vigorous role in these areas. Board committees' informational investment—the information necessary to arrive at authoritative conclusions about financial results, material risks and trends, legal compliance, and reputational and institutional challenges—is synthetic, synergistic. That informational investment, which was lacking in the monitoring board model, also furnishes the basis for advising the CEO about strategy, and evaluating its success. The final section of Part II traces the recent expansion of fiduciary duties relevant to informational governance, especially *Caremark* "informational infrastructure/oversight" duties. We examine some recent judicial decisions which hint at where an informational orientation to board governance may take the law.

A. Corporate Identity Formation

Legally and functionally, boards are professional bodies whose authority and power lie in knowledge and communication acts. Directors bring individual expertise to bear on the discussion of data and reports from a host of firm actors and advisers. They receive and deliberate over reports, both oral and written. They absorb this data and information, debate opinions about them, arrive at shared views about future directions for their firm, through majority voting and board resolutions, supervise reporting within and by the firm, and then, once again, anticipate, demand, and command follow-up data gathering, reporting and attendant action.

In sum, the crucial role of the board is to develop and promulgate compelling and shared understandings of what the firm is, has been, and will be, as the predicate for rational action. We envision the board as a locus of communicative action where the best information meets searching, careful discussion, direction, and documentation about the firm's status, prospects, leadership, and potential. When the board engages in this identity formation, its analysis and decision making is recapitulated through the many levels of organized leadership and action which constitute the firm.[129] The board's investment in data gathering, deliberation and reporting processes as constitutive of the firm's status—its "identity"—generates significant value for the firm.[130]

Once so stated it seems obvious: coordinating, framing, and prioritizing the flows of information and communications within the firm is a governance function that is instrumental to intelligent decision making by boards and executives, a predicate to maximizing competitive advantage. No one is better positioned than the board to do this high level, "reaching across the enterprise" work of requisitioning robust internal reporting and candid communications. At no time has it been as clear that good board leadership is predicated on directors being extremely well informed prior to endorsing the initiation and implementation of corporate actions.

This isn't work adequately done by markets or "the market," although that was the hope. Even in a nexus of contracts world, someone needed to be coordinating the parts (contracts) so that they wouldn't be duplicative or incoherent. It isn't the responsibility of the firm's bankers, lawyers, or other advisers, each of whom come at different problems and tasks with local priorities and incentives. The CEO's resources are best targeted at strategy initiation and execution, as Fama and Jensen theorized. The monitoring-versus-managing apportionment of responsibility wasn't so much wrong as incomplete, as it relates to the board. With the focus on external markets, the monitoring function left out the necessity of boards demanding coordinated, intelligent, information gathering and reporting—and becoming invested in the results of this reporting—as a basis for fostering the firm's competitive advantage.

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[129] *Accord* NACD, URGENT IMPERATIVE, *supra* note 1, at 12 (the board-management relationship should take the form of "an iterative collective-learning process").

[130] For a consideration of corporate identity in relation to "norms," see Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619 (2001); Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?* 44 UCLA L. REV. 1009 (1997).

Board action in informational governance is informed by a cascade of federal statutes, SEC regulations, SRO listing mandates, PCAOB and SAS requirements and expanded *Caremark* and candor fiduciary duties. Collectively they effectuate a detailed, intensive schema of board participation in shaping and authorizing the authoritative account of the firm's financial condition, principal trends in operations and risks, and formulation of legal compliance policies and ESG oversight practices. In terms of liability, the responsibility for the accuracy of the financial statements and integrity of internal controls lies principally on management's shoulders. Boards can repose reasonable reliance on the financial data presented by management and the auditor. But boards, audit committees especially, have functional responsibility for demanding candor and material completeness in their firm's reporting, and its infrastructure. This is so, now, not merely by virtue of professional custom and best practices, but also as a result of a supportive scaffold of statutes, SEC rules, SRO mandates, auditor requirements and board fiduciary duties; this is an elemental feature of informational governance.

The cascade of new board governance rules and requirements catalyzed by Sarbanes-Oxley and Dodd-Frank could not have shaped board practices as they have were it not for personal computing, smart phones, and nearly universal recourse to data sharing via email and internet-based platforms, as they have evolved in the past twenty or so years. Old-style governance—in which information and communications were shared in person at meetings and in paper reports—has given way to new modality of board governance existing in a nearly continuous stream of reporting, review, and feedback. The next subsection discusses the impact that advances in information technology have had on board governance practices and, ultimately, corporate governance and securities law.

B. The Role of New Information Technology

As late as the early 1990s, the CEO's office, or office of the Corporate Secretary, would release reports to directors, for board meetings, in hard copy (on paper), delivered by Federal Express. Professional practice, in law and elsewhere, has changed fundamentally, almost inconceivably, in a relatively short time.[131] Deliberation of the kind expected of board members today looks very different from the "show up at the boardroom having read the paper report" world of the recent past. Governance, now, looks more like a

[131] Up until about 1990, in order to establish the ongoing validity of a precedent (i.e. shepherdize a case), a lawyer could easily need to go to a library and peruse several hard volumes, including a "pocket part supplement." Leading professionals relied on administrative staff to type their work product.

constant stream of emails, some with attached documents of considerable complexity, punctuated by text messages, phone calls, video conferencing and virtual meetings, as well as in-person ones. Without smart phones, laptops or tablets, and personal computers, this revolution would not have occurred. It's nearly inconceivable that the first iPhone was released only in 2007.

The information technology revolution has altered the costs and speed, and hence possibilities, of board attentiveness. Work has spread into professional life 24/7, for worse and for better. Business enterprise itself has become far more virtual—less dependent on hard assets, central physical locations, or elbow grease. The old construct of singular corporate hierarchies is outdated. The boundaries of the firm—so essential to Coasean thought—have become diffuse. (As an extreme example, the construction of Boeing's commercial jets depends on a supply chain of 5,400 global entities.[132]) Contemporary board governance isn't factory floor meta-oversight, but information governance. Official corporate reports are complemented, at times superseded, by reporting by employees or watchdogs, which can go "viral" via social media with shocking rapidity and effect. Both fellow employees' attitudes (which influence recruitment, productivity and retention, which involve costs) and customers' attitudes (which influence profits, of course) can be altered fundamentally by these informal reporting channels.

"Informal," extra reporting by employees, the media and watchdog groups adds pressure to boards' control over the formal, mandatory and discretionary, channels of reporting. Whereas the monitoring board model implied a degree of reactivity in board action—alert directors being *responsive* to inappropriate managerial action in shareholders' defense—such a reactive board posture is no longer sufficient. It simply leaves firms too exposed. The process of reputational formation will occur, whether boards get on top of it or not—which is why they must, consistent with their authority and fiduciary duties. This is why "corporate identity formation" accurately describes an important part of the board's informational governance.

C. Domains of Corporate Narrative

Where does the macro-level identity of the corporation show up in the experience of the firm's participants? Contemporary corporate governance has looked especially to bottom line financial metrics, financial statements, and stock prices as the principal signifiers of what the firm is and can be. Perhaps decades ago, it was more

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[132] NAT'L INST. OF STANDARDS AND TECHNOLOGY, U.S. DEP'T COMMERCE, BOEING AND EXOSTAR: CYBER SUPPLY CHAIN RISK MANAGEMENT, at 2.

plausible to focus on hard assets like manufacturing facilities or principle offices or headquarters, as expressions or anchors of corporate identity and status. Modern firms, more likely to be global, asset-light, and highly dependent on subcontracting, often elude these old metrics of corporate identification, or at least exceed them. As stock market prices become more volatile, they too are becoming unreliable signifiers of the firm's status. It is no longer a "no-brainer" to define what the firm is—what its principal assets and forms of value are, or how they align with a strategic plan and set of risk metrics—and then to convey this information to the relevant constituencies. If corporate boards previously relied on lawyers, investment bankers, or their senior executives to accomplish these tasks and goals, we argue such passivity appears increasingly risky and wasteful.

Traditional corporate governance has paid little attention to the sourcing, curating, and shepherding of information and communications as critical sources of firm value. But an emerging field of organizational behavior focuses precisely on this subject and processes in enterprises of all kinds. This new academic field, which grew out of Media Studies research but is now firmly incorporated into Organizational Studies, is called "Communication Constitutes Organization" ("CCO"). Having emerged in North America universities in the 1990s, CCO research is synthesizing insights from transaction cost economics, management theory, behavioral science, semiotics, and sociology. Perhaps the core CCO insight is that any productive enterprise requires human collaboration, which arises from communication that stimulates coordination of effort and capital. Shifting away from the study of mathematized models of inputs and outputs, CCO theorists focus on information and communication as ideational frameworks which successively and recursively shape and incentivize the selection, prioritization, and application of capital inputs, as well as the evaluation of results. Ideas and communication precede rational, collective action and judgments about the production of value.[133]

An extraordinary array of texts, symbols, and other modes of communication shape a company's core set of commitments, goals and processes. Cumulatively, these "texts" drive the next level of messages circulating inside firms to employees, and then beyond the firm, to shareholders and others. The most obvious external

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[133] Corporate law, too, has grappled with the question of how to define what the firm "is," as evident in the legal standard for a sale of "substantially all assets." In 1974, in *Gimbel v. Signal Companies, Inc.*, the Delaware Chancery Court enunciated the rule that although quantitative metrics are significant, no predetermined tests can resolve whether a material sale of assets rises to the level of altering the fundamental identity of a corporation—"qualitative" factors remain critical, and situation specific. In so holding, the court implicitly affirmed the importance of narrative in defining the essential identity of a corporation.

messaging—constituting an autobiography of the firm—is the detailed account of the firm's business, property, principle markets, financial results, trends and risks, material litigation and regulatory deficits as revealed in quarterly and annual SEC filings, and the Annual Report to Shareholders. It is difficult to remember that integrated disclosure, which shapes and supports one facet of this corporate autobiography, is only a few decades old. In these decades, the scope and subjects of corporate SEC reporting —both calendar driven reporting and special event/transactional reporting—has grown exponentially in depth and breadth. At the same time, the SEC has emphasized the role of the board (including, explicitly, nonexecutive, independent directors) in overseeing the candor and completeness of SEC reports 10-Q, 10-K, 8-K, Schedule TO, 14d-9, and the Annual Reports to Shareholders.

Along with SEC reports, corporations are vastly expanding their narrativity through their webpages and voluntary sustainability (ESG) reports, whether online or otherwise. These are all self-initiated representations of the corporation's actions and commitments; they are expanded upon by general employee and executive codes of conduct, corporate mission statements and internal compliance and risk management policies, and so on. These internal documents, too, are critical signifiers of what the corporation is and is intended to become. They reflect past corporate conduct and shape future conduct. Investor litigation is a feedback mechanism in public reporting as corporate "auto-biography." Where a corporation's actions have departed substantially from its disclosures in SEC filings, corporate press releases or other official corporate public statements, the companies have faced securities lawsuits and attendant liabilities. Where a corporation's self-described status or conduct has departed from its promises in codes of conduct, compliance commitments and CSR/ESG reports, they have faced employee lawsuits, public shaming, possible boycotts or loss of goodwill. These feedback loops tie corporate narrativity to business realities.

The domain of corporate narrativity has altered fundamentally in the past two decades. Corporate webpages have become critical portals of information and opinion formation—and yet they are less than three decades old in usage and almost entirely untheorized in corporate governance. In these decades, the role of investor relations departments and corporate communications departments has burgeoned—all in furtherance of shaping opinion about what the firm does, is, and will become. There has also been a tremendous expansion of access to corporate books and records under the statutory state law inspection process. This means that minutes of board meetings, internal memoranda and reports of investigations, and other critical board decisional documents have instrumental weight in influencing shareholder responses. It is sometimes stated that corporate reports and disclosures are synthetic, meaning their genesis cannot be parsed

between management, lawyers, directors and other experts. This is often held to be true for securities liability purposes. But the liability vantage point doesn't resolve the governance one. Board leadership is critical in the selection of the C-Suite, and should be highly influential in the selection of other critical advisers who influence the gathering, reporting and synthesis of seminal corporate information.

In sum, board leadership lies considerably in focusing, disciplining, and making critical decisions about the firm's messaging, in all its textual incarnations. Boards cannot and should not manage all of the firm's critical disclosures and communications, any more than they manage all of the firm's commercial affairs. However, they need to exercise judgment over this domain of resources, as they do with traditional capital assets. Hence, overseeing the candor and coherence of the firm's financial and internal reports, corporate codes and compliance policies, and voluntary and web-based disclosures is a critical dimension of board value creation.

D. Audit Committees and Financial Reporting

The audit committee's active participation in the financial reporting process exemplifies the board's informational governance. This is true for at least four reasons. First, the robust participation of the audit committee in the financial reporting process cannot be squared with the model of the monitoring board. The role of audit committee directors is more direct, proactive, and intensive than monitoring implies, and the audit committee's role has independent significance beyond evaluating the CEO. Second, the quantitative and textual financial reports produced under the aegis of the audit committee are essential to the board's understanding and evaluation of the status of the firm and what it is capable of. Third, information produced by the committee is synthetic. Financial data and reports illuminating the firm's status are relevant to the board's advisory role in strategy, which informs the board's perspective on the CEO, which then influences board compensation decisions, and also ESG governance such as pay ratio disclosure. Fourth, while directors' participation on audit committees illustrates the apogee of the board's informational governance, the difference is only one of degree. The directors on other committees staffed exclusively by non-management board members—the compensation and nominating committees, at minimum—also do work that is communicative action shaping the firm's identity.

The foundations of informational governance lie in the 2000s. The changes wrought by Sarbanes-Oxley first elevated the role of audit committees to the preeminent stature they hold in board governance today. Nevertheless, Congress, as usual, intended for its legislation to

inspire further rules. Hence, Sarbanes-Oxley's provisions, as incorporated into the '34 Act, are only one feature of the new rules specifying directors' active leadership in financial reporting. Equally influential in shaping audit committee conduct are SEC rules, NYSE and NASDAQ listing requirements, and especially companies' own committee charter requirements.[134] Audit committee leadership arises also from PCAOB rules and by SAS pronouncements requiring auditors to discuss material auditing and accounting matters with the committee. In sum, there now exists a detailed scaffolding of rules compelling audit committee leadership in the production of materially complete financial statements and reports.

The audit committee exercises authority over a reporting team that includes the external auditor, the CFO, and perhaps the CEO, heads of business units, the corporate controller or chief accounting officer, and the internal audit department. Each of these professionals has a different, more local function in the process. In addition to the lattice of federal, SRO, charter, and accounting and auditing literature requirements, also relevant to the audit committee's work are the fiduciary duties of candor, care (becoming fully informed), and *Caremark* oversight duties. In sum, the audit committee does not have the option to play a passive role in the financial reporting process if it wishes to be in compliance with existing rules and standards. This is the ground floor of informational governance.

It is the audit committee and not the auditors which lead the company's financial reporting process. Underscoring the audit committee's leadership, SEC rules mandate that the audit committee, and not management, is responsible for hiring, firing and supervising the conduct of the outside auditors.[135] The audit committee determines the scope and terms of the audit, and fees payable to the audit firm. The audit committee is responsible for scrutinizing and determining the independence (from management) of the audit firm. In this vein, the committee has responsibility to approve any non-audit services conducted by the audit firm, since non-audit fees might compromise the outside auditor's rigor and independence in the audit.[136]

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[134] *See* REPORT OF THE NACD BLUE RIBBON COMMISSION ON THE AUDIT COMMITTEE (2010) at 30-44 (Appendix A: Dodd-Frank Act, SOX, NYSE, and NASDAQ Requirements).

[135] 17 CFR § 240.10A-3(b)(2).

[136] 1934 Section 10A 15 U.S.C. Section 78j-1(i), added by SOX Section 202; 17 C.F.R. § 210.2-01(c)(7). For NYSE companies, the audit committee must at least annually, obtain and review a report by the independent auditor describing its internal quality control procedures. There is a roughly analogous NASDAQ requirement. As part of supervising the audit, the audit committee must negotiate or review the auditor's terms of engagement; maintain a "direct, open line of communication" with the auditors, receive the auditor's reports, monitor the auditor's performance, and make

Both NYSE and NASDAQ listing standards require that the audit committee enumerate its responsibilities in a publicly-disclosed charter.[137] The base-line of rigorous leadership by the audit committee is very high.[138] For example, the committee is generally expected to meet in executive session, separately, with the outside audit firm, the inside auditors and management. Based on audit best practices this should occur at minimum quarterly. This now common practice exemplifies the audit committee's leadership and participation in the process that yields the authoritative financial self portrait of the firm—one that influences everything else.

Cumulatively, the rules make apparent that audit committee leadership is not administrative, but genuine participation in executive decision making over financial reporting. The audit committee members are expected to inform themselves of the nuts and bolts information in the financial statements and MD&A, and why the data is what it is. By inference, this encompasses determinations, on the audit committee's part, about data which was excludable, under GAAP, SEC rules and the securities laws, as being immaterial. A number of overlapping rules and pronouncements, including directors' duty of care, codify that the audit committee should be asking these kind of probing, material questions on an ongoing basis. Scrutinizing the numbers, choices of accounting policies, accounting estimates, and textual disclosures in the MD&A (which encompasses critical information about operating results, risks and market trends) is everywhere presented as part of the audit committee's obligation.[139] The auditor rules back up the audit committee's duty of inquiry and oversight.[140] SEC and PCAOB rules expressly require the auditor to

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final determinations concerning issues that arise during the audit. Again, the rules contemplate active leadership by the audit committee.

[137] NYSE 1999 Audit Committee Listing Rules, 64 Fed. Reg. at 71530 (noting NYSE Listed Company Manual, 303.01(B)(1)(c)); NASDAQ 1999 Audit Committee Listing Rules, 64 Fed. Reg. at 71523 (noting NASD Rule 4310(c)(26)(A)(ii)).

[138] The charter of a NYSE company's audit committee *must* state the audit committee's responsibility to: "meet to review and discuss the listed company's annual audited financial statements and quarterly financial statements with management and the independent auditor, including reviewing the listed company's specific disclosures under Management's Discussion and Analysis of Financial Condition and Results of Operations." NYSE Listed Co Manual Section 303A.07(b)(iii)(B). The NASDAQ rule is slightly more open ended, but essentially the same. The SEC requires that the audit committee disclose whether it has "reviewed and discussed the audited financial statements with management." 17 C.F.R. § 229.407(d)(3)(i)(A). Thus the SEC has imposed a disclosure-based analog to the duty of care in this context.

[139] *See, e.g.*, Sarbanes Oxley Section 204, adding Section 10A(k) to the Securities Act of 1934, 15 U.S.C. § 78j-l; 17 CFR § 210.2-07; NYSE Listed Company Manual.

[140] Accounting industry standards require auditors conducting a review of interim financial information to report to the audit committee any material modifications

support the audit committee's scrutiny not only of the financial reports generally, but of particular, critical matters such as the review of related party transactions.[141]

SEC rules provide that the audit committee must oversee the resolution of substantive disputes over financial reporting methods if they arise, whether between the external and internal auditors or between the outside auditor and management.[142] PCAOB and SAS standards expand on the range of reporting matters to be evaluated and discussed between audit committee members and the audit firm. The latter require auditors to present and evaluate critical accounting matters with the audit committee.[143] After mutual discussion, the Auditor's Report becomes incorporated into the Form 10-K filing with the SEC. The Auditor's Report is required to contain a review of any sensitive judgments or unusual transactions—matters which the rules mandate would have been discussed with the audit committee. Hence, the Report constitutes an enduring, public record of the resolution of matters arrived at in consultation between the audit committee and the rest of the financial reporting team.

True, nowhere in this network of formal requirements does it expressly state that "the audit committee directors must read and understand their firm's financial statements and results of operations, risks, and business trends." This requirement is implicit in the federal, SRO, charter, and auditing mandates, including those requiring the audit committee to discuss the quarterly and annual reports with the other members of the audit team. It arises, too, from their duty of care, which operates at all times in directors' actions.[144] The express requirement that the audit firm discuss the accounting methods employed in the financial statements, material features of the audit process, and the substance of the Audit Report with the audit

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required to bring the financial information in conformance with GAAP, any frauds involving senior management or resulting in a material misstatement of the financial statements, possible illegal acts (unless inconsequential), and matters that, in their judgment, represent significant deficiencies in the design and operation of internal controls. Auditing Standard 4105, SAS 100, Paragraphs 29-30.

[141] Congress itself, in Sarbanes-Oxley, enacted rules to mandate auditors' support for audit committee leadership. PCAOB rules also document matters that must be discussed between the audit committee and the outside auditor. Under PCAOB Auditing Standard 1301, the auditor has a duty to facilitate audit committee oversight. PCAOB Auditing Standard 1301, "Communications with Audit Committees," available at https://pcaobus.org/Standards/Auditing/Pages/AS1301.aspx. The PCAOB also requires the audit firm to discuss any "critical audit matters" it has identified with the audit committee. PCAOB release No. 2017-001.

[142] This feature of intensive audit committee involvement must be reflected in the audit committee charter, as per NYSE and NASDAQ requirements.

[143] *Id.*

[144] *See* Lyman P. Q. Johnson, *The Audit Committee's Ethical and Legal Responsibilities: The State Law Perspective*, 47 S. TEX. L. REV. 27, 35-36 (2005).

committee presumes that the committee members would achieve fluency in understanding the financial statements and reports.

The audit committee's financial reporting responsibilities—which are continual, i.e., without break—are discharged through the creation and re-creation of a public narrative about the company's financial condition.[145] The committee's leadership encompasses not only the annual report to shareholders, but also the annual reports on form 10-K (including its MD&A), and the firm's interim, quarterly financial statements (including their MD&As). These reports are searchable online at the SEC's webpage, and are customarily posted on the firm's webpage as well. Hence, they constitute a very public narrative about the company's financial position and projected status. The unavoidable subjectivity in financial reporting helps explain why audit committee directors' independence from management is mandatory and essential, and why the audit committee's leadership of the financial reporting process is critical to discerning—indeed, *defining*—the firm's financial status. The ongoing nature of corporate reporting, as well as its public status, reinforce the rationale (and indeed, fiduciary basis) for the audit committee's informational investment here—to understand the substance of the financial reports. The SEC rule requiring a majority of the board to sign the Form 10-K further emphasizes the directors' duty to understand the substance of the financial reports.[146]

Driving home the idea that the audit committee directors must obtain a full understanding of the financial reports is the SEC rule requiring each audit committee to contain a "financial expert," or disclose (embarrassingly) that it does not.[147] Beyond disclosure, a substantive requirement for the committee to have a financial expert arises from the SROs standards. Importantly, the SRO and PCAOB auditor rules prescribing what must be discussed, reviewed and authorized do not refer to the financial expert, but *to the audit committee in toto*. A financial expert is defined expressly as someone adept at comprehending the accounting and financial presumptions operating in financial statements and reports subject to GAAP.[148] The financial expert is positioned as a backstop to raise the level of the full committee's literacy in GAAP and GAAS. But the presumption of understanding the firm's financial and operating status lies not only

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145 *Accord* 2018-2019 NACD PUBLIC COMPANY GOVERNANCE SURVEY (2018), at 25 (describing board engagement as "a continuous process").

146 *See* Form 10-K, General Instruction D(2)(a)'s requirement that a Form 10-K be signed by a majority of the board be signatories.

147 *See* 17 CFR §§ 228, 229, 249 [RELEASE NOS. 33-8177; 34-47235; File No. S7-40-02]. In addition, a series of authorities require that all audit committee members be independent of the company.

148 Lawrence J. Trautman, *Who Qualifies as an Audit Committee Financial Expert Under SEC Regulations and NYSE Rules*?, 11 DEPAUL BUS. & COM. L. J. 205 (2013).

with the full audit committee but, because the audit committee has a duty to relay its understanding, with the board in full.

In sum, federal statutes, SEC regulation, SRO listing mandates, PCAOB and SAS requirements all demand the *active* leadership of the audit committee in the issuance of sound financial accounts of the firm's condition and results of operation, principal risks, and trends. The process through which these financial reports—narratives about the company's financial status—are produced is *continual*; given the quarterly nature of financial reporting, at least the audit committee chair, if not the other members of the committee, would be in near-constant communication with the larger financial reporting team. It is *substantive*, requiring a real informational investment by audit committee directors. And the process is not optional, since it is mandated by law.

Finally, the portrait of intensive audit committee participation in the production of the annual and quarterly financial statements and reports specified above assumes normal times. In situations where there was severe financial stress threatening the firm's status as a going concern, or in a situation where fraud or misstatements were feared, or other extraordinary risks or transactions were pending, the audit committee's work would expand. This emergent portrait of contemporary audit committee leadership demonstrates that board governance has become an intensive effort, one that shapes the cognizable reality of the firm. The language of "oversight" does not capture this reality, which lies more in "communicative action."

E. Boards in Risk Management and Legal Compliance

More intensive board leadership in overseeing risk management and legal compliance is also a new normal, albeit one which is not reflected in as large a set of formal rules as applies to financial reporting.[149] For financial reporting, risk management, legal compliance and even strategic advising, the informational governance idea melds systemic responsibilities with a firm's unique status. For example, informational governance contemplates that each firm's board will take a unique tack in adapting and prioritizing risk governance. The same is true for legal compliance oversight and management. For example, the intensity or priority of risk management and legal compliance will vary firm-by-firm, but should be a focus of board attention in *every* firm. The focus and seriousness

[149] For a discussion of enhanced risk management responsibilities of boards at financial institutions after Dodd-Frank, see Kristin N. Johnson, *Addressing Gaps in the Dodd-Frank Act: Directors' Risk Management Oversight Obligations*, 45 U. MICH. J. L. REFORM 55 (2011).

with which a firm addresses risk and legal compliance will influence the firm's value—a traditional facet of investor concern—but also the firm's culture, an increasingly significant facet of concern to myriad constituencies.[150]

Based on the conventional structure of internal control, dating back to COSO and the late 1970s,[151] it is often the audit committee which leads oversight of risk management and legal compliance (in addition to financial reporting). Reflecting this convention, the NYSE corporate governance rules provide that the audit committee should support "board oversight of ... a listed company's compliance with legal and regulatory requirements."[152] But a board's risk oversight governance doesn't need to be in the audit committee per se. The precise contours of board governance in risk management and legal compliance are more fluid than in financial reporting governance, where responsibility sits squarely on the audit committee.[153] That the locus of the board risk management and legal compliance governance is flexible makes sense, because it has relevance across the spectrum of corporate governance (and informational governance). Legal compliance and risk management affect strategy, compensation choices and CEO retention, and decisions relevant to tone-at-the-top and ESG governance.[154] Rather than to the audit committee, a firm might assign this role to another principal board committee, a specified risk management committee or to the full board in its entirety. Nevertheless, there is public accountability on the process selected: the SEC requires detailed disclosure of a firm's board-level risk oversight

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[150] Again, informational governance takes a synthetic view of board leadership as communicative action. This is why risk and legal compliance are matters which come under the purview of nominating and governance committees, and the full board as well, not just audit committees.

[151] For an analysis of the historical scope and breadth of the internal control concept and practice, see generally Lawrence A. Cunningham, *The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism, Other Ills*, 29 IOWA J. CORP. L. 267 (2004).

[152] NYSE Listed Company Manual § 303A.07(b)(i)(A).

[153] *See* Business Roundtable, Principles of Corporate Governance, August 2016, at 16 ("Unless the full board or one or more other committees do so, the audit committee should oversee the company's compliance program, including the company's code of conduct. The committee should establish procedures for handling compliance concerns related to potential violations of law or the company's code of conduct, including concerns relating to accounting, internal accounting controls, auditing and securities law issues.").

[154] For discussion of the merits of a separate risk committee, see Matteo Tonello, Should Your Board Have a Separate Risk Committee? (2012) https://corpgov.law.harvard.edu/2012/02/12/should-your-board-have-a-separate-risk-committee/; "Board Risk Oversight – A Progress Report: Where Boards of Directors Currently Stand in Executing their Risk Oversight Responsibilities," Protiviti, December 2010 (www.coso.org/documents/Board-Risk-Oversight-Survey-COSO-Protiviti_001.pdf).

process. Clearly this is intended to elevate the substance of governance.[155] The SEC, too, practices *communicative* action.

In the case of financial firms, the Dodd-Frank Act requires more formalized and rigorous financial risk oversight procedures, including board level oversight.[156] Even outside of financial firms, heightened expectations in risk management and legal compliance are being mirrored in recent "upscaled" *Caremark* duty to monitor holdings.[157] Not only legal compliance failures, but increasingly, business risk management failures are moving into the ambit of *Caremark's* fiduciary schema governing board vigilance.[158] In *Sarbanes Oxley*, Congress made express the obligation of managers to report material legal non-compliance all the way to the board, if necessary to accomplish a satisfactory remedial response.[159] The decision to tie risk-management officers' legal duties (and personal legal exposure), to their responsibility to inform their board should they uncover material irregularities, has eroded directors' capacity to plead ignorance as a defense. Heightened board sensitivity to potential legal exposure (albeit extraordinarily rare) has had a systemic effect on intensifying board governance practices in this area. Of course, the board's awareness of risk and legal compliance problems (or even reckless failure to be informed) influences their securities class action liability

[155] The SEC considers risk oversight a primary responsibility of the board and requires disclosure of its role in this area. The relevant S-K provisions are Item 402(c) and 402(n) of Regulation S-K, 17 CFR § 229.402(c) [RELEASE NOS. 33-9089; 34-61175; IC-29092; File No. S7-13-09].

[156] Dodd-Frank requires a separate risk committee for certain nonbank financial companies and certain bank holding companies. The Board of Governors may require a publicly traded company with total consolidated assets of less than $10 billion to establish a risk committee to promote sound risk management practices. See Dodd-Frank Act Section 165(h).

[157] For discussion of enhanced duties and potentially liability under recent duty to monitor decisions, see, e.g., Gadinis and Miazad, *The Hidden Power of Compliance*, 103 MINN. L. REV. 2135, 2164-79; see also, Alan R. Palmiter, *Duty of Obedience: The Forgotten Duty*, 55 N. Y. L. SCH. L. REV. 457 (2010/2011).

[158] *See also* Marchand v. Barnhill (finding existence of management-level compliance program not enough on its own for board to avoid liability); *In re Clovis Oncology, Inc. Derivative Litigation* (finding board of life sciences experts should have been on notice of problems with drug trials and addressed flawed reporting).

[159] *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 307, 116 Stat. 745 (codified as amended at 15 U.S.C. 7245 (2002)). Section 307 of the Act requires the SEC to prescribe minimum standards of professional conduct for attorneys appearing and practicing before the SEC, including a rule: "(i) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any of its agents to the CLO or the CLO and CEO of the company or the equivalent thereof; and (ii) if the CLO and/or CEO does not appropriately respond to such report, *requiring the attorney to report the evidence to the audit committee, another committee of the board of directors* composed solely of individuals not employed by the issuer or the full board of directors." (emphasis added).

exposure,[160] as well as potential *Caremark* liability. These have been potent motivators to enhanced board governance of risk management and legal compliance, and a catalyst to remedial action.

The Federal Sentencing Guidelines also function as an incentive to enhanced board oversight of legal compliance, as was observed in 1996 in *Caremark* itself. Under the Guidelines, the executive with operational responsibility for legal compliance oversight must expressly have authority directly to communicate with the audit committee (or other appropriate governing body) overseeing legal compliance.[161] Firms which can demonstrate solid board governance targeted at fostering firm-wide legal compliance are likely to obtain lesser penalties if problems do occur.[162] Moreover, the Justice Department increasingly requires upgrades to corporate compliance programs, reaching to the boardroom, as part of settlements via deferred prosecution or non-prosecution agreements.[163] In egregious cases, the DOJ insists on the imposition of an outside, board-level monitor to raise the level of firm-wide legal compliance.[164]

Recent proposed updates to the SEC's S-K reporting requirements on risk and legal proceedings disclosures are also reshaping and upgrading board governance of their firms' risk management and legal compliance.[165] Expanded transparency is, in turn, fostering investors' and other constituencies' enhanced attention to ESG-related risk factors, reinforcing a cycle feeding into upgraded

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[160] On the issue of scienter as grounds for board liability, see, e.g., *Tellabs, Inc. v. Makor Issues & Rights, Ltd*, 551 U.S. 308, 324 (2007) (a finding of scienter need not require a "smoking gun" but must be "cogent and compelling" in light of other explanations).

[161] *See* § 13.02[2][b][iii]; U.S. Sentencing Commission, Federal Sentencing Guidelines Manual, § 8B2.1 and § 8C2.5(f) (Nov. 1, 2018).

[162] A Department of Justice Compliance Memorandum addresses the matter. It suggests that one of the first questions prosecutors will ask is what, if any, compliance expertise has been available to the board. In assessing penalties, they may consider whether the board has held executive sessions with compliance leaders within the company and may inquire as to what types of information the board has examined in its exercise of the oversight function. Key questions will be what types of issues have been reported to the board, and how the board and management have addressed them. Documentation as to board discussions and decisions will be necessary to show that the board has been diligent in fulfilling its oversight responsibilities. Memorandum of the Criminal Division of the U.S. Department of Justice, updated 4/2019, available at https://www.justice.gov/criminal-fraud/page/file/937501/download.

[163] For discussion of the practice of DPAs and NPAs, see, e.g., Rachel E. Barkow, The New Policing of Business Crime, 37 SEATTLE U. L. REV. 435 (2014); and Lawrence A. Cunningham, *Deferred Prosecutions and Corporate Governance: An Integrated Approach To Investigation And Reform,* 66 Fla. L. Rev 1 (2014).

[164] *See* Khanna and Dickinson, *The Corporate Monitor: The New Corporate Czar?,* 105 MICH. L. REV. 1713 (2007).

[165] 17 CFR §§ 229, 239, 240, Release Nos. 33-10668; 34-86614; File No. S7-11-19.

board-led governance efforts.[166] The scope of new and existing required risk factor disclosure, and statements regarding corporate stewardship of risk and legal compliance, impact ESG pressure from institutional investors, and hence expanded board oversight.[167] Enhanced disclosure feeds investor pressure and heightened standards for board oversight. Because the process is recursive and iterative, board level vigilance is reinforced.

Accordingly, since the 2000s, most public companies have overhauled their staff radically to expand the employees tasked with risk management and legal compliance.[168] This increased hiring and emphasis on legal compliance governance in U.S. firms is, of course, a redirection of corporate resources occurring under the board's authority, within its discretion. Most importantly for informational governance, there is a regulatory, professional and industry consensus that risk management and legal compliance are enterprise capabilities, not simple functions. They can be effectuated by corporate managers, on their own, within the middle layers of the enterprise—this is where "tone at the top" is board level communicative action. As Caremark itself noted, the scope of operational and reputational damage which can be effectuated by rogue actors within an organization mandates instituting rigorous internal controls reaching to the board.[169]

In order to achieve effective results, risk management and legal compliance internal controls need to be integrated with board leadership. That is, the board oversees the establishment and effective operation of multiple, direct, independent, but backstopping channels of reporting, none of which can be circumvented by C-Suite officers

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[166] *See, e.g.*, Council of Institutional Investors, *How Corporate Boards Can Combat Sexual Harassment* ed. Rosemary Lally and Brandon Whitehill (March 2018).

[167] *See, e.g.*, Virginia E. Harper Ho, *Risk-Related Activism: The Business Case for Monitoring Nonfinancial Risk*, 41 J. CORP. L. 647, 653 (2016) (arguing that accounting for both financial and nonfinancial risk can drive firm and portfolio performance). For ESG risks' relationship to conventional interpretations of "materiality," see Ruth Jebe, *The Convergence of Financial and ESG Materiality: Taking Sustainability Mainstream*, 86 AM. BUS. L. J. 645 (2019).

[168] *See* Gadinis and Miazad, *Hidden Power of Compliance*, 103 MINN. L. REV. 2135 at 2146 ("In the last ten years, the explosive growth of compliance departments has redefined the corporate landscape, demanding extraordinary resources and upending established corporate governance hierarchies.").

[169] Despite the emphasis on stock price monitoring by boards, Gordon notes the emergence of a "controls monitoring" duty on the board's part. *See* 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, 1540 (2007) ("Directors, then, will have a particularized monitoring role, which might be called 'controls monitoring,' in addition to 'performance monitoring.'"). Our treatment of the subject differs substantially from Gordon's by focusing on controls monitoring as a stepping stone for actual board leadership in corporate affairs, to the point of defining the firm's orientation to a broad set of financial, operational, legal, and socially-relevant matters.

having an incentive to suppress red flags. This is entirely compatible with gains in, corporate investments in information technology. The informational governance board rejects the presumption of the "informationally-captured" board, which had no basis in law, and lacked awareness of contemporary communications technology. To the degree boards may require institutional support to compile the relevant information and communications necessary to fulfill their duties, administrative supports will develop. The office of the Corporate Secretary is an underdeveloped institutional resource, which could be recast to report to the board rather than management. To serve in this domain might be a "board ombudsman,"[170] or an administrative board suite.[171]

From an informational governance perspective, an essential insight is that risk management and legal compliance are not finite tasks or "check the box" functions where the firm arrives at "done" and can move on. This dimension of informational governance demands reframing as "capability" of firms, executed under the board's leadership, linked to value creation in creating the right culture and reputation. Stepping back, it becomes clear that legal noncompliance is a subset of risk, and risk is a subset of strategy—an area of governance executed at the highest level.[172] To emphasize—given the complexity and scope of financial and operational risks, and the multiplicity (federal, state and regulatory) of legal mandates addressing firms' conduct in this area, addressing risk and legal compliance is a feature of strategy which by necessity engages issues belonging to board judgment and discretion—board leadership. How much risk to shoulder in seeking return? How much legal compliance to effectuate before the costs become prohibitive? How little to invest without risking penalties or reputational catastrophe?

Expanded transparency and stakeholder scrutiny, in combination with the unavoidable uncertainty accompanying each firm's achievement of an optimal equilibrium in its risk management and legal compliance responsibilities, mandate board attention to these matters, along with the C-Suite's. Governing risk management and legal compliance becomes a matter of senior level business strategy, since reputation and potential financial penalties bear immediately on

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[170] Lynne L. Dallas, *The Multiple Roles of Corporate Boards of Directors*, 40 SAN DIEGO L. REV. 781 (2003).

[171] Kobi Kastiel & Yaron Nili, *Captured Boards: The Rise of Super Directors and the Case for a Board Suite*, 2017 WIS. L. REV. 19 (2017).

[172] For a story of an epic legal compliance and risk oversight failure at Goldman Sachs, see *Plaut v. Goldman Sachs Group, Inc. et al.*, Sep. 19, 2019, 18-CV-12084 (VSB) (S.D.N.Y. Sep. 19, 2019); Dennis Kelleher, *Goldman Sachs and the 1MDB Scandal*, May 14, 2019, https://corpgov.law.harvard.edu/2019/05/14/goldman-sachs-and-the-1mdb-scandal/.

corporate wealth.[173] The exercise of board discretion and judgment, in risk management and legal compliance, means that each firm will have an individual signature—an identity achieved through board leadership. The firm's own reporting (mandatory and discretionary, including on its web page), media reporting, and social media reporting telegraph this signature identity to investors, customers and employees. This is the new reality of boards in informational governance.

F. Boards in Strategy

Our proposal builds on the upsurge in demand for robust, creative strategic management in American corporations. The monitoring board's contribution to strategy was limiting managerial waste. Informational governance assumes higher aspirations for the board. While, as now, the board delegates responsibility for *initiating* and *executing* strategy to the CEO, informational governance contemplates a thicker, more collaborative strategic advisory role for the board.[174] The new paradigm presumes directors dedicated to acquiring in-depth, firm-specific knowledge, complementing their individual expertise. Committee duties once categorized as administrative are, rather, domains for corporate expertise-building which position directors to contribute to strategy. Moreover, the current ease of communications technology, and firms' enhanced data reporting systems support this capability. Surveys indicate that directors themselves are enthusiastic about having an expanded role in strategic advising.[175]

It is not up to CEOs, legally or technologically, to permit or prevent boards from engaging robustly in strategic advising. Nominating Committees should be well aware, by now, of the enterprise risks associated with imperialistic CEOs. Technology no longer positions CEOs to capture corporate information in order to

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[173] For discussion of the strategic dimensions of the governance of legal compliance, see Constance E. Bagley, *What's Law Got to Do with It? Integrating Law and Strategy*, 47 AM. BUS. L.J. 587, 600 (2010).

[174] For discussion of board strategic advising in the legal literature, see Jill E. Fisch, *Taking Boards Seriously*, 19 CARDOZO L. REV. 265 (1997); Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L. J. 797 (2001); Lynne L. Dallas, *The Multiple Roles of Corporate Boards of Directors,* 40 SAN DIEGO L. REV. 781 (2003).

[175] *See, e.g.,* NACD, URGENT IMPERATIVE, *supra* note 1 (May 2019 director poll found that 86% of directors "fully expect to deepen their engagement with management on new drivers of growth and risk in the next five years"); Vincent Firth, Maureen Bujno, Benjamin Finzi & Kathy Lu, *Seven Steps to a More Strategic Board*, DELOITTE INSIGHTS (July 8, 2019) ("directors want to be more involved in strategy," to "contribute more value" and to "use their full range of talents"); Chinta Bhagat, Martin Hirt, & Conor Kehoe, *Tapping the Strategic Potential of Boards*, MCKINSEY QUARTERLY (Feb. 2013) (two out of three surveyed directors want to spend more time on strategy).

subvert boards' capacity to play an active, genuine role in strategy. As Melvin Eisenberg wrote in the *Cardozo Law Review* in 1997, boards should insist on multiple, overlapping but independent channels of information reaching them directly without possibility of CEO bias.[176] Boards also have the power to hire independent advisers, including management consultants, to shed impartial light on strategic alternatives.

Hence, informational governance envisions directors as truly empowered within the common project of ensuring the firm's prosperity. Indeed, corporate identity *formation* contemplates boards will engage in *defining what the firm's prospering means*. Rather than focusing on the shortcomings of outside directors, we see this cohort as uniquely structurally *enabled* to provide CEOs a constructive sounding board in strategy formation. The simple practice of requiring CEOs to present their strategic plans to (now increasingly well informed) directors stands to make a contribution. It's likely to discourage CEO strategies that are too egoistic, rash, thinly conceived, or ill-fitting with the firm's competitive position and environment. As peers secure in their positions, board members are free to dig in—bring both their firm-specific and their individual knowledge to bear—and deliberate over their firm's future.

Some of the increased demand for better strategizing is being fueled by fears of short-termism, as associated with activist hedge funds and otherwise. Despite record high stock prices, there is palpable economic malaise challenging U.S. firms' stature and prestige. Slow growth, economic insecurity and rising inequality are creating populist turmoil, including resentment against large companies. High stock prices and positive GDP metrics have not tracked other troubling measures of corporate performance. Companies have commonly used free cash flow (and tax breaks) to buy back shares, raising complaints that they are failing to invest in their firms' longer term futures, including that of their employees. No longer is record high CEO pay receiving unqualified endorsement as justified by high stock prices. The underlying tenets of antitrust policy are also being reconsidered, reflecting worry that record consolidation has enabled oligopoly to undermine wages, sustainability and innovation.[177] These legal, social, and macro-economic pressures are presenting challenges to business strategy that CEOs should not resolve on their own without board input and consensus.

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[176] Melvin A. Eisenberg, *The Board of Directors and Internal Control*, 19 CARDOZO L. REV. 237 (1997); *see also* Steven A. Ramirez, *The End of Corporate Governance Law: Optimizing Regulatory Structures for a Race to the Top*, 24 YALE J. REG. 313, 334 (2007) (discussing excess managerial freedom in corporate law).

[177] TIM WU, THE CURSE OF BIGNESS: ANTITRUST IN THE NEW GUILDED AGE, (2019); Lina M. Khan, *Amazon's Antitrust Paradox*, 76 YALE L. J. 710 (2106).

Surveys indicate that directors are themselves seeking a larger role in the strategic planning process.[178] Directors are advocating for a larger role in strategic planning notwithstanding their greater time commitment and responsibility in financial reporting, and oversight of risk and legal compliance. Or perhaps it's on account of it, since being more deeply informed, by virtue of active committee service, gives directors greater depth in strategic planning. For many boards, prestigious strategy work is a "reward" for the heavy lifting of committee work.

Because this Article isn't an encyclopedic account of boards in informational governance, we have omitted a treatment of Compensation Committees' work. It is apparent, nevertheless, that directors' participation in strategy formation should improve their capacity to assess the CEO's *execution* of the strategy as relevant to CEO compensation and retention decisions; as expressed earlier, information flows in informational governance are synthetic. The monitoring board relied principally on external, stock price signals to assess CEO success. Informational governance shifts the focus to illuminate how internal board experience, advising on financial reporting, risk and legal compliance, and strategy—in addition to stock prices—enables better board judgments about compensation and retention.

Business strategy is conventionally associated more with the fields of management and finance than law. But law is crucial to the board's authority in strategy. To review, by statute in every state boards of directors are granted preeminent discretionary authority over corporate affairs, to manage or direct, as they see fit. The CEO's authority is delegated from the board's statutory authority, and documented in board resolutions vis a vis non-ordinary affairs. Sales of substantially all assets, a sale or substantial expansion via a merger, the declaration of special dividends or share repurchases—these corporate acts cannot be commenced other than by consent of a majority of directors. The board, of course, chooses the firm's CEO—the primary actor in setting strategy—and may terminate the CEO if the firm's strategy is a failure.

To provide room for reasonable adventurousness in strategy, the law ensures that neither boards nor CEOs are financially liable for business losses from failed strategies, normally. So long as the strategy was chosen in good faith, based on all reasonably available information, the business judgment rule ensures that shareholders

[178] *See supra* note 179.

cannot hold the board or CEO liable for attendant business losses.[179] (This fiduciary due care requirement provides an additional incentive for boards to ensure they are fully informed in their strategy oversight role.) Financial conflict-of-interest transactions and egregious shortfalls in directors being informed can result in personal liability for directors, but only in truly extraordinary circumstances largely within their control. Liability for corporate "waste" is virtually nonexistent—pertaining to instances of board judgment falling outside *any* creditable strategy. Business judgment deference in litigation is also a pillar of board leadership in informational governance.

In sum, the law provides that board authority and discretion is constitutive of corporate strategy formation, notwithstanding the freedom and respect afforded CEOs in this domain. The monitoring model masked full recognition of board authority and discretion in setting corporate goals and objectives, not because there was ambiguity over it, but because recognition of this wide discretion did not comport with broader features of that agency cost paradigm.

In law, interestingly, there is no duty mandating boards to govern strategy, or govern "strategically."[180] Broad, nonspecific nostrums in the equitable jurisprudence advise directors (and officers) to act in the best interests of the firm and shareholders, become informed, and avoid financial conflicts. One might assume this gap in fiduciary law arises from law's tendency to attend to the "downside" of affairs—the avoidance or resolution of conflicts.[181] Yet this is not the case; fiduciary duties have an aspirational, "upside" orientation, as well as one demarcating standards of liability. As for fiduciary duties touching on "strategy," the case law simply avoids express mention of the subject, as such. Constructs of strategy operative in the field of management (through MBA education, consultants and research) have not infused law. Nor do fiduciary duties locate where along the spectrum of shareholder profit maximization or stakeholder governance a board must set corporate sights.

Both shareholder wealth maximization and stakeholder governance—indeed the full spectrum of strategic board discretion—are congruent with existing fiduciary tenets and the board discretion they validate. Informational governance embraces this board discretion. We argue that enhanced transparency is the ideal monitor of this fiduciary and corporate discretion, rather than law or legal

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[179] On the duty of care generally, see DAVID KERSHAW, FOUNDATIONS OF ANGLO-AMERICAN CORPORATE FIDUCIARY LAW (2018).

[180] This realization is first noted in the legal literature by Nadelle Grossman. *See* Nadelle Grossman, *The Duty to Think Strategically*, 73 LA. L. REV. 449 (2013).

[181] Melvin A. Eisenberg, The Divergence of Standards of Conduct and Standards of Review in Corporate Law.

commentators dictating some end purpose of business corporations. Moreover, law dictating that profit maximization, or stakeholder governance, should control is incompatible with the "enabling" feature of corporate law which has existed for over a century.

Mirroring the silence regarding boards' participation in strategy in fiduciary jurisprudence, legal scholarship has mostly failed to inquire about boards' role in strategy.[182] Most pointedly, as illustrated in Part I, the "monitoring" board—as it was intended to focus intently on limiting managerial agency costs—was not the "strategy" board. Legal corporate governance research acknowledged in passing that boards might fruitfully advise the CEO about strategy, but the discussion went no further, remaining generic, nonspecific.

There was a pervasive assumption that non-management directors could not contribute much to CEOs' project of strategy formation, and probably should not try. The view was, first, that CEOs would resent and prevent it. Second, there was a presumption that non-management directors could not be sufficiently informed to be genuinely useful. Third, there was a presumption that non-management directors had little incentive to dig in and engage in strategic advising (a presumption which ignored, or masked, the prestige and enjoyment of power in the role). Relative ignorance about the inside of their firms was accepted as if a necessary tradeoff for independence—-an assumption the informational governance model rejects. We believe we have demonstrated that new technology, new legal requirements, and new expectations for directors' roles refutes the model of the detached, thinly-informed director.[183] In the new mindset, the opportunity to influence the identity of a major public company, including its business strategy, posture towards risk and the law, and its ESG profile, are powerful draws encouraging talented executives to board service.

The role of *outside* directors in strategy formation is a functionally vital one. Vetting the CEO's strategic plan, with authentic candor, is not plausibly an option for an insider or affiliated director. Where they could be fired by the CEO, as is true for inside directors, they cannot not afford to bring constructive criticism to bear on the CEO's strategic vision. Inside directors would have to say "yes"—thereby fostering groupthink, as well as greater overconfidence bias in

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[182] Ronald J. Gilson & Jeffrey N. Gordon, *Boards 3.0: An Introduction*, 74 BUS. LAW. 351 (2019); Nadelle Grossman, *The Duty to Think Strategically*, 73 LA. L. REV. 449 (2013).

[183] *See, e.g.*, NACD, URGENT IMPERATIVE, *supra* note 1, at 12 (proposing that board leaders "position boards as more proactive in providing direction and shaping future strategy").

the CEO,[184] both of which often being highly destructive for firms. The bedrock desire for independent judgment in directors evaluating a CEO's performance *ex post* is equally germane to vetting a CEO's strategy *ex ante*. But to make a meaningful contribution, directors' professional independence (security of livelihood and independence of mind) has to be complemented by meaningfully deep firm-specific knowledge, as we discuss herein.[185]

The field of strategic management has fruitfully leveraged big data, enhanced reporting technology software, and quantitative analysis. Data and information science have ramped up to such a degree that commentators are already foreseeing a role for machine learning in corporate governance.[186] But what is overlooked too often is that strategy is also a narrative process. Corporate data does not speak for itself. To become meaningful, data demands inferences about causality, probability, and market competitors' conduct—*all projected into the future*. This narrative orientation towards strategy illustrates how it fits with the discretionary, conscientious view of board informational governance. Data gathering, deliberation about the resultant information, probing questioning—these are part of the narrativity in strategy formation. Accordingly, requiring the CEO to engage the non-management directors on the board in the process of explaining, examining, and narratively reconstructing the firm's strategic plan can be extremely valuable to the firm.

As distinct from strategy *execution,* which is inevitably bespoke, strategy *formulation* builds on two predominant schools of thought in management science. While impossible to summarize here, they should be noted because they provide authoritative, widely accepted, rigorous entree to serious considerations of strategy by boards. Variations on these two academic strategy traditions are employed, commonly, by management consulting firms.

One is the so-called "Resource-Based View of the Firm," arising from the influential research of Edith Penrose.[187] To discern

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184 *See, e.g.*, Marleen O'Connor, *The Enron Board and the Perils of Groupthink*, 71 U. CIN. L. REV. 1233 (2003); James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW CONTEMP. PROBS. 83 (1985).

185 Once we concede that local stock market prices are incomplete signals about the quality of a CEO's strategy, then directors serving on the Compensation Committee must also be well informed about the terms and parameters of the CEO's chosen strategy.

186 John Armour & Horst Eidenmueller, *Self-Driving Corporations?*, ECGI Law Working Paper No. 475/2019 (Nov. 19, 2019) (forthcoming).

187 *See generally* EDITH PENROSE, THE THEORY OF THE GROWTH OF THE FIRM (1959); *see also* R. L. Priem & J. Butler, *Is the Resource-Based 'View' a Useful Perspective for Strategic Management Research?*, 26 ACAD. MGMT. REV. 20 (2001); Birger Wernerfelt, *A Resource-Based View of the Firm*, 5 STRAT. MGMT. J. 171 (1984).

the sources of a firm's competitive advantage, in order to capitalize on it, the resource-based view of the firm demands a searching interrogation of which corporate assets or resources (tangible or intangible) are "rare, valuable and relatively inimitable." The resource-based view of the firm is nearly universally taught in business schools. Its basic framework would be familiar to virtually every director with an MBA.

The same is true of the second major school of strategic thought, arising from the research of Harvard Business School's Michael E. Porter.[188] Porter's work is as famous among MBAs as Coase's is among University of Chicago Law Students. He is still actively teaching and researching at Harvard, and is a sought after consultant. Porterian strategy adopts a five-part heuristic for analyzing a firm's competitive status within its industry and larger competitive environment, and the firm's most likely path to success. Notably, despite their comprehensive influence on management science, neither the resource-based view, nor Porter's five forces analysis, are particularly quantitative models of strategy, though econometric and other quantitative metrics are used in employing the theories, of course. The point is that directors do not need to do regression studies to have a vital grip on thinking about the strategic future of their firms. Nor do they need to proceed *ex nihilo* to have a framework for analyzing their CEO's strategy. There are clear, widely accepted models to ground boards' discussions of their CEO's preferred strategic alternatives.[189]

All of this suggests that corporate governance might benefit from the selection of different kinds of board candidates. Nominating Committees might focus less on the pool of retired and current CEOs, and more on mid-career executives intent on growing professionally along with their firms. Directors who have full-time employment will serve, ideally, on one board at a time. The greater churn in executive labor markets, as well as the greater representation of women and minorities in elite professional networks, suggests there will be no shortage of highly qualified candidates. Web-based, professional search technology is likely to genuinely up the ante. Beyond the question of pay, which is now substantial, public company board positions confer power, prestige and access to elite networks (which can later be monetized). Charter exculpation, indemnification, D&O

188 *See* MICHAEL E. PORTER, COMPETITIVE ADVANTAGE: CREATING AND SUSTAINING SUPERIOR PERFORMANCE (1985); MICHAEL E. PORTER, COMPETITIVE STRATEGY: TECHNIQUES FOR ANALYZING INDUSTRIES AND COMPETITORS (1980).

189 Of course, there are CEOs who adopt an instinctive, ineffable approach to strategy, and would avoid board level discussion of strategy. In such case the full board would have to evaluate whether to tolerate that degree of CEO autonomy. (Blind luck, too, is at times more influential than is planning, but no one would suggest leaving a company's future up to luck.).

insurance, the business judgment rule, the demand requirement, heightened pleading requirements, forum selection bylaws, and myriad other legal and logistical hurdles ensure that directors acting conscientiously face near zero personal liability exposure.[190]

In sum, although corporate governance has under-emphasized the role of independent directors in strategy formation, developments in information technology, more intensive director committee requirements, as well as clear, evolved frameworks for strategic analysis, now position directors to make a valuable contribution in this area. Strategy formation isn't a gnostic art; the informational governance board is strategically enabled.

G. ESG as Part of Boards' Role in Informational Governance

Boards' increasing focus on ESG matters fits the informational governance thesis. In recent years, we have seen significant board-level attention devoted to sustainability reporting, ESG shareholder proposals, and corporate culture.[191] All of these involve enhanced informational commitments and produce compelling and shared understandings of the firm's identity that are then recapitulated through the organization. At the same time, the invention of the benefit corporation, and the proliferation of benefit corporation statutes across the nation, also underscore not only the public interest in socially responsible business, but also the increased role for boards of directors in companies that take such concerns seriously.[192]

1. <u>Board Stewardship of Issues Raised by Shareholder Proposals</u>

Beginning in 2017, in a series of Staff Legal Bulletins, the SEC's Division of Corporation Finance began encouraging boards of directors to provide a written, board-level analysis of the excludability of a shareholder proposal when a corporation requests a No Action

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[190] *See* Rene Otto & Wim Weterings, *D&O Insurance and Corporate Governance: Is D&O Insurance Indicative of the Quality of Corporate Governance in a Company?*, 24 STAN. J. L. BUS. & FIN. 105 (2019).

[191] *See, e.g.*, NACD, URGENT IMPERATIVE, *supra* note 1, at 16 (86% of the S&P500 now publish annual sustainability reports, compared to 20% in 2011); DELOITTE & SOCIETY FOR CORPORATE GOVERNANCE, BOARD PRACTICES REPORT 2018, at 7 (56% of directors surveyed anticipate that their companies will increase disclosure related to CSR, sustainability, and social impact over the next 12 to 18 months).

[192] *See* Joan MacLeod Heminway, *Corporate Purpose and Litigation Risk in Publicly Held U.S. Benefit Corporations*, 40 SEATTLE U. L. REV. 611, 618-25 (2017) (discussing some of the unique attributes of benefit corporations and their relation to board leadership).

Letter from the Division.[193] Asserting that a company's effort to exclude a proposal under the "ordinary business exclusion" can involve "difficult judgment calls that we believe are matters that the board of directors generally is well-situated to analyze," the Division emphasized that a "well-developed discussion of the board's analysis" could assist the corporation in demonstrating to the Division that a proposal is excludable.[194] Although the Division has said that this new, board-level submission is not required to obtain a No Action Letter, the Division's special emphasis on it has created new obligations for a board considering an exclusion. For one thing, it shifts oversight of the underlying policy issue from the C-suite to the board, and ensures that board-level consideration occurs (and is memorialized in writing) even for proposals that the firm seeks to ignore. The Division has stated that it believes that the board is "the appropriate body with fiduciary duties to shareholders" to give "due consideration as to whether the policy issue presented by a proposal is of significance to the company."[195] The Division's decision to ask for board analyses thus makes the corporation's response to issues raised by shareholder proposals (rather than just the corporation's handling of the proposals themselves) a matter of the board's fiduciary obligation.

In addition, because shareholder-proponents often pursue the same reform year after year, the result of the Division's move will be, at many companies, a written chronology of the board's consideration of the underlying issue, be it social, political, environmental, or governance-related. The net effect is to make the board—rather than the usual players, the C-suite officers—the steward of the underlying substantive issue over a potentially long time horizon, and to create a public paper trail of the board's treatment of the policy issue over a course of years—an important communication about the firm's commitments. It makes the board's stewardship of the issue not only a fiduciary obligation for the board, but also its expression of the firm's purpose, operation, and intentions—its identity.

2. "Tone at the Top"

The abuses which led to the Great Recession focused the world's attention on corporate culture. As the research of Yale law professor

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[193] *See* SEC, Division of Corporation Finance, Staff Legal Bulletin No. 14I (November 1, 2017); SEC, Division of Corporation Finance, Staff Legal Bulletin No. 14J (October 23, 2018); and SEC, Division of Corporation Finance, Staff Legal Bulletin 14H (October 16, 2019).

[194] SEC, Division of Corporation Finance, Staff Legal Bulletin 14H (October 16, 2019) ("If a request where significance is at issue does not include a robust analysis substantiating the board's determination that the policy issue raised by the proposal is not significant to the company, our analysis and ability to state a view regarding exclusion may be impacted.").

[195] *Id.*

(and psychologist) Tom Tyler demonstrates, ethical, pro-compliance corporate cultures can flourish only where there is a perception of strong "buy-in" from the board and the firm's senior-most executives. This insight is often described with the label "tone at the top." It recognizes that information does not just flow up the reporting chain to a passive board, but also down from an active and engaged board through all the strata of the organization.[196] In this picture, the board is not only a recipient of information about the firm, but also an author of the firm's ethical identity. Through a significant immersion in corporate data and reporting systems, and by overseeing the creation of ethical, conscientious corporate policies, the directors instantiate the commitment to accountability that can motivate and unify the firm in moving forward.[197]

In "tone at the top," we can see the outlines of the shift from the agency-cost model of the board to the informational governance model. The agency-cost model focuses on creating incentives that shape agents' behavior, and firms could treat "tone at the top" as an incentive exercise. But increasingly, boards are communicating "tone at the top" as part of a broader "ethical culture"—and doing it in a wide range of corporate texts directed at employees, investors, customers, and regulators. The creation of an ethical culture is not primarily about calibrating incentives for agents (although it presumably helps shape employees' behavior), but about a set of information- and communication-based actions by the firm's leadership: learning about the firm's cultures and sub-cultures, synthesizing an ethical identity across all of the firm's sub-units, and communicating that ethical identity effectively, and continually.[198]

H. Boards' Fiduciary Informational Duties

Under *Caremark* and its progeny, boards must demonstrate a pattern of genuine inquiry, give attention to the systemic architecture of internal data gathering and reporting, and produce a considered response to the results.[199] The evolution of *Caremark* duties provides some of the best evidence that informational demands on the board

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[196] *See, e.g.*, TRUST IN ORGANIZATIONS (R. Kramer & T. Tyler, eds., 1996); Tom R. Tyler, *Reducing Corporate Criminality: The Role of Values*, 51 AM. CRIM. L. REV. 267 (2014).

[197] *See* Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735 (2001) (noting the role of board governance in building productive internal firm culture as a valuable asset); NACD, URGENT IMPERATIVE, *supra* note 1, at 12 ("corporate culture" is one of the items on the board agenda that "really matters").

[198] *See also* Tamara Belinfanti & Lynn A. Stout, *The Value of Systems Theory for Corporate Law*, 166 U. PA. L. REV. 579 (2018).

[199] *See* Caremark; Stone v. Ritter, 911 A.2d 362 (Del. 2006).

are increasing, and that this path leads to better corporate governance. Informational governance provides a framework to understand this evolution, and justifies the shift in favor of enhanced *Caremark* duties by recognizing the creation of (and attendance to) informational architecture as a core role of the board. It connects the board's active participation in informational practices to the board's satisfaction of its fundamental duty of loyalty.

In a widely observed recent case, *Marchand v. Barnhill,* the Delaware Supreme Court emphasized that the board could not simply rely on management's compliance efforts or discretionary reporting on operational matters.[200] In that case, an ice cream manufacturer failed to remediate an outbreak of deadly bacteria in one of its manufacturing plants, leading to three deaths.[201] The company's board had not been informed about "yellow and red flags" about the bacterial outbreak, because it had no informational architecture that required reporting such flags up to the board, and because the company's officers had exercised their discretion to provide the board with limited information about the growing problem.[202] The Delaware Supreme Court held that the company's board could violate its *Caremark* duties by failing to implement a system to keep itself informed about the company's food safety performance and compliance. To discharge its *Caremark* duties, the court held, the board had to undertake a good faith effort to establish a food safety risk oversight system *at the board level* and then *participate in* the system.[203] Relying on this "two-prong" approach endorsed by *Barnhill*, a Delaware chancery court recently rejected a motion to dismiss a complaint that successfully plead a violation of *Caremark* duties where the board of a pharmaceutical company had ignored red flags that reached it through information processes focused on its regulatory approvals.[204]

Starting in the mid- to late 1990s, then, *Caremark* and its progeny have expressed the board's duty of loyalty, in part, in terms of its good-faith execution of informational practices.[205] As the Delaware

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[200] Marchand v. Barnhill, No. 533, 2018 (Del. June 18, 2019).

[201] *Id.*, slip op. at 1.

[202] *Id.* at 5 ("the complaint alleges that Blue Bell's board had no committee overseeing food safety, no full board-level process to address food safety issues, and no protocol by which the board was expected to be advised of food safety reports and developments" and "the board was not presented with any material information about food safety").

[203] *Id.* (In short, to satisfy their duty of loyalty, directors must make a good faith effort to implement an oversight system and then monitor it."); *see also* In re Clovis Oncology Derivative Litig., slip op. at 2 (placing emphasis on the board's obligation to *monitor* an oversight system) (October 1, 2019) (Slights, V.C.).

[204] In re Clovis Oncology Derivative Litig., slip op. at 36-43.

[205] For a recent synthesis of *Caremark* and its progeny, see Elizabeth Pollman, *Corporate Oversight and Disobedience*, 72 VAND. L. REV. 2013, 2021-25 (*forthcoming* 2019).

Supreme Court put it in *Barnhill*, "the board must make a good-faith effort—i.e., *try*—to put in place a reasonable board-level system of monitoring and reporting."[206] The word "reasonable" suggests that as informational best practices evolve, courts will hold boards responsible for updating and improving those practices at each firm. What is reasonable will turn not only on the company's unique business and risk profile, but on the technology and organizational practices that make it possible for the board to collect and process information critical to the business, and to appreciate the seriousness of "red flags." As information technology and organizational practices improve, the expectations for board competency will ratchet up. Exculpation for duty of care violations (and the business judgment rule) will continue to protect directors from personal liability for poor judgment in the *use* of the information, but the board's responsibility for robust informational practices will limit any "blind spot" defense.[207] Boards operating in good faith will increasingly be held liable for ignoring red flags.

Given the growing importance of information flows and communicative action to board governance, we might expect courts to raise the bar for disclosure-related fiduciary duties and "cleansing" tools in other contexts. This includes duties of directors to make disclosures to shareholders, as well as disclosure obligations upon which the "cleansing" effect of shareholder votes will turn.[208] And it includes duties of officers to disclose information up to the board. In recognition of the importance of "reporting up" red flags to the board, Jennifer O'Hare has proposed a "duty to inform" bylaw that would require the CEO and CFO to promptly inform the board of information it needs to manage the firm.[209] Whether firms adopt such a bylaw or, instead, the law changes to recognize a duty, it seems obvious that the board cannot engage in informational governance without an obligation on the part of the corporation's officers to

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[206] *Id.* at 30-31.

[207] *Accord* In re Clovis Oncology Derivative Litig., slip op. at 2 (placing emphasis on the board's obligation to *monitor* an oversight system) (October 1, 2019) (Slights, V.C.) ("as relates to *Caremark* liability, it is appropriate to distinguish the board's oversight of the company's *management of business risk* that is inherent in its business plan from the board's oversight of the company's *compliance with positive law*—including regulatory mandates").

[208] *See* Malone v. Brincat, 722 A.2d 5 (1998); Shannon German, *What They Don't Know Can Hurt Them: Corporate Officers' Duty of Candor to Directors*, 34 DEL. J. CORP. L. 221, 230 (2009) (describing *Malone* as "t[ying] together" directors' "duty of honesty to shareholders not only in communications seeking shareholder action—whether for approval or ratification—but also '[w]henever directors communicate publicly or directly with shareholders about the corporation's affairs, with or without a request for shareholder action'").

[209] *See* Jennifer O'Hare, *Private Ordering and Improving Information Flow to the Board of Directors: The Duty to Inform Bylaw*, 53 U. RICH. L. REV. 557 (2019).

provide them with material information on any subject within the board's purview.

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As the above demonstrates, the role of boards in informational governance is expanding. New demands placed on audit committees exemplify the board's increasing investment in information and communication practices. Over time, fiduciary duty also has become increasingly concerned with the management of information. Federal law, SRO rules, and investor demands have pushed boards to expand their spans of attention to a range of concerns, including ESG matters and corporate strategy. Informational governance recognizes that boards play a value-creating role at the command center of the firm's information architecture. By making an investment in the firm's knowledge and communication systems, the board turns collectivity into enterprise rather than chaos.

CONCLUSION

This Article has argued that the agency-cost/"monitoring board" paradigm and the separate spheres concept reflect a dated approach to board governance. Four decades ago, Fama and Jensen divided the governance world into monitoring and managing, creating a conceptual dichotomy that influences corporate law to this day. Boards assumed the monitoring role, while the C-suite performed the executive function. What got lost in the elegant monitoring-versus-managing trope is that good oversight of the firm cannot happen in the absence of a well-informed base-line of information and shared communications. Stock price signals are thin, often tardy substitutes for this thicker knowledge about the firm. The COVID-19 pandemic and recent stock market turbulence have only underscored weaknesses inherent in stock-price-based corporate governance.

Governance changed radically in the 2000s, in the aftermath of Sarbanes-Oxley and attendant developments reflecting widespread fears of legal compliance and risk management failures. The widely shared belief that governance failures were also implicated in the global financial crisis also brought pressure to bear on the field of governance, and produced the Dodd-Frank Act and ensuing SEC regulations. These changes, along with technological and macroeconomic developments, are still being assimilated by governance actors, regulators, and researchers today.

However, what is clear is that a new approach to board governance is taking shape. Informational governance, including a conscious process of corporate identity formation, describe the board's management and authoritative deployment of knowledge and

communication as the basis for rational collective action in the firm. It embodies an active, rather than a passive, approach to board governance. It is both a normative improvement on the stale "monitoring board," and a new and better framework for understanding corporate governance law as it currently exists.

Importantly, directors' participation in financial reporting, and risk management and legal compliance oversight constitute investments in valuable firm-specific knowledge. This firm-specific knowledge is a capital asset that compounds in value, for directors and firms, when it is brought to bear on board level consideration of the CEO's strategic plans. Recent shocks to our systems of public health and finance have only heightened the importance of these informational assets and firms' systems of information gathering, synthesis, and strategy. The future of corporate governance is board-level informational governance.