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Corporate Governance Update: The Broadening Basis for Business Judgment

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The Securities and Exchange Commission recently revised the periodic disclosure requirements of Regulation S-K, the latest installment in the SEC's ongoing effort to improve the quality of public disclosures. In many instances, the new rules replace prescriptive requirements with flexible guidelines intended to elicit company- and industry-specific information that is material to investors' understanding of the company's business. The SEC's move toward a principles-based disclosure framework centered on materiality can be understood as part of a trend in the United States and Europe toward increasing the scope of board and management discretion. For most of their history, U.S. public corporations were widely understood to be profit-driven enterprises governed by a rule-based corporate law regime designed to protect and advance the financial interests of shareholders. There is now a growing transatlantic view that corporations should be better understood as purpose-driven entities working toward "sustainable profitability" and guided by ethics, social responsibility, and values, all as defined by the board of directors in its business judgment. While the business judgment rule in the United States will continue to protect decisions made in good faith by unconflicted directors, one consequence of expanding the purpose of the corporation would be that directors' decisions need no longer be targeted to the singular goal of maximizing shareholder returns.

The stakeholder governance model, particularly in the context of a more flexible regulatory regime, effectively increases the discretionary authority of boards and managers. Boards increasingly are expected—and in Europe may be required, in the foreseeable future—to consider a wide array of factors including corporate purpose, all corporate stakeholders, sustainability, and even the well-being of society and the economy at large. Managers, by the same token, have new latitude under the principles-based disclosure requirements to create and provide the information they see as material in this wider context. These broad mandates may fit the contours of the current moment in unexpected ways. Events of 2020 have turned the spotlight onto corporate America's role in creating and perpetuating societal inequities, a development that has put enormous pressure on corporations to publicly adopt stakeholder-centric positions. The highly concentrated institutional ownership in today's stock market—and asset managers' widespread endorsement of the stakeholder model—may further drive boards to adopt an expanded view of corporate purpose in their decision-making.

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The Principle of Materiality

The revisions to Regulation S-K, adopted in August, shift the emphasis of the periodic disclosure requirements from rule-based compliance to principles-based judgments. Drafters of corporate disclosures will have to employ a greater degree of discretion to determine what, and how much, information investors need in order to understand the company and its position in the industry. This process will require thoughtful consultation with internal and, in some cases, external advisors. To decide which information to present publicly, management will have to base their periodic disclosures on a robust understanding of the company's purpose, mission, strategy, and strategic time horizon.

The principle behind the revisions—that disclosures should be "material to an understanding of the business"—is repeated throughout the new rules. For example, Regulation S-K Item 101(c), which calls for a "Narrative Description of the Business," formerly required disclosure of a prescribed list of items. The new requirement contains a nonexclusive list of topics, many of which had been required, that must be addressed only to the extent that they are material to an understanding of the company's business. The standard applies in some cases to time frames as well as topics; for example, in Item 101(a), which calls for disclosure regarding "General Development of the Business," a five-year look-back has been eliminated. Instead, companies must disclose information "material to an understanding of the development of their business," with flexibility to determine to the time frame required to meet that standard. In other words, under the revised rules, the content (topics addressed), the extent (level of detail), and the time frames (look-backs) for disclosures are now largely to be determined by companies based on their judgments as to the materiality of relevant, company-specific information. These revisions may lead to disclosure that is oriented toward longer time horizons in the context of strategic planning and that is forward-looking in anticipation of trends in business development.

To be sure, issuers' discretion is not limitless under the revised rules. Chairman Jay Clayton has said that he expects companies to include "meaningful qualitative and quantitative disclosure, including, as appropriate, disclosure of metrics that companies actually use in managing their affairs" and "to maintain metric definitions constant from period to period or to disclose prominently any changes to the metrics." In some cases, the new requirements continue to use numeric thresholds for disclosure, such as in Item 103, "Legal Proceedings." As a general matter, however, corporate managers working to comply with the new regulations will have to engage deeply in the process. Market practices regarding materiality determinations—with respect to content, detail, and timeframe—are likely to evolve over time. It is also likely that the SEC staff will issue additional interpretive guidance as needed to clarify the new requirements and address issuers' concerns.

Global Trend Toward Broad Discretion

Transatlantic pressure for companies to move from the shareholder primacy model to the stakeholder governance model has intensified in recent months. In August, the European Commission, which has been exploring possible European Union action to increase the "long-term economic, environmental and social sustainability of European businesses," published a comprehensive study of directors' duties and sustainable corporate governance. The study includes a set of recommendations for possible EU legislative and nonlegislative actions to discourage short-termism and promote stakeholder governance.

The EC report's recommendations include the following: that directors acting in the interests of their company "should properly balance the following interests, alongside the interest of shareholders: long-term interests of the company (beyond 5–10 years); interests of employees; interests of customers; interest of local and global environments; [and] interest of society at large." The study also recommends that boards "integrate sustainability aspects (risks, opportunities, impacts) into the business strategy" and suggests "promoting the principle that identifying and mitigating sustainability risks and impacts, both internal and external, is part of directors' duty of care."

The conclusions of the EC report indicate that European leaders view stakeholder governance as a matter potentially affecting long-term European prosperity. The EC's willingness to consider strong legislative action at the EU level should be seen as a warning signal for American business. While the Business Roundtable embraced the stakeholder governance model last year and the incorporation of ESG factors into the core purpose of corporations, and while lawyer Martin Lipton's New Paradigm has grown in influence since its publication in 2016 by the World Economic Forum, there is a strong consensus among U.S. proponents of this model that voluntary, widespread adoption is essential to avoid legislation that would lead to the state corporatism now apparently being considered by the EU.

Business Judgment Today

The business judgment rule has been a key element in the success of American business over time, as it enables directors to take calculated risks with the understanding that their good-faith decisions—even if ultimately misguided or unprofitable—will be protected. The expanded board mandate and discretion inherent in the stakeholder governance model are viewed by some as overly broad and inadvisable to the extent that the directive to maximize shareholder returns may be diluted. Yet it is worth noting that the shareholders of today are not those of a century ago. The U.S. corporate legal system could not have anticipated the dramatic consolidation of stock ownership in the hands of a few institutional investors. The "mom and pop" shareholders envisioned by traditional corporate law might, in this new world, need directors to prioritize the interests of the company, broadly defined, rather than simply attempting to maximize the financial interests of shareholders. Those interests are, in any case, harder than ever to define, as the institutional mega-investors, the short-term-oriented funds, and the comparatively marginalized individual investors have very little in common.

While the idea that a company's investors may not all be aligned is not new—the short-term/long-term conflict has raged for decades, after all—what is increasingly important is that different types of long-term investors also appear to have widely divergent interests. There is also the unprecedented fact that the largest and most powerful investors, which are larger and more powerful than anyone in 1933 and 1934 (or even 1968) could have imagined, are strong proponents of the stakeholder governance model. In this modern context, a shift toward a broader basis for director discretion in the service of a more expansive mandate means that, as Mr. Lipton recently wrote: "It is the corporation, qua corporation, that commands the fiduciary duty of its board of directors." Broad-based decision-making at the board and senior management levels may be the most pragmatic way for corporations to pursue a profitable path forward.

There is a certain existential nature to the questions facing companies at this moment. The purpose of a corporation is being redefined. Managers are now being asked to determine what is "material to an understanding of the business" for disclosure purposes, a question that can only be answered by reference to that corporate purpose, as well as corporate strategy across a strategic time horizon. Boards are being asked to consider the good of society at large in making decisions for their stakeholders. The basis for business judgment is broader than ever before.