In It for the Long Haul

Boards of Directors Can and Should Switch Their Emphasis from Short-Term Profits to the Long-Term Vitality of a Corporation

So writes Nadelle E. Grossman, Assistant Professor of Law, Marquette University, in this edited excerpt from "Turning a Short-Term Fling into a Long-Term Commitment: Board Duties in a New Era," which appeared in the summer 2010 issue of the *University of Michigan Journal of Law Reform*.

There is significant pressure on boards of directors, both from executives as well as from investors, to oversee businesses that generate profits in the short-term. That often leads to board decisions directed at producing profits over a short period of time, such as six months or a year, without regard to the ill effects of those decisions on the longer-term health of the business. This tendency to manage for the short-term, or "short-termism," in large part explains the near collapse of institutions, such as AIG and Merrill Lynch, that seemed almost impregnable not long ago, as these institutions failed to address the long-term risks associated with their mortgage-related investments.

The pressure from executives on boards is widely believed to be due in large part to executive-compensation arrangements that reward executives for short-term profits. Yet executive-compensation arrangements alone may not explain excessive short-termism by boards. Rather, board short-termism also seems to be due to some investors, with short investment horizons, who use activism to influence boards to make decisions that yield short-term returns despite the longer-term impairing effects those decisions might have on the corporate enterprise.

Yet even with these pressures on boards to create short-term value, a director is supposed to have an unyielding fiduciary duty to act in the best interest of the entire corporate enterprise of which she is a director. This is reflected in the fiduciary duties every director owes to that corporation and its stockholders.

Thus we must ask—are directors, by furthering the short-term interests of investors and executives, meeting their fiduciary duties? Or do—or more importantly, should—fiduciary duties require that they oversee a corporation's affairs with a view to furthering the corporation's sustained success?

To implement the strong public policy in favor of corporations that are managed for the long-term, as well as the general coincidence of corporate interest in the long-term, I propose that directors be required to make decisions primarily for the purpose of advancing the long-term best interest of the corporation and its stockholders. That means that every time the board is faced with a business decision, it would need to consider how that would benefit the corporation and the stockholders in the long-term and make decisions that are aimed at achieving that objective. In effect that would mean that directors would need to determine how every business decision implemented the corporation's business plan, for the business plan sets out the corporation's long-term objectives as well as strategies to achieve those objectives. That would not mean that the board must shape corporate strategy such that a corporation forgoes all opportunities to make current profits—but it would mean that realizing on current profits could not undermine the corporation's ability to generate profits in the future in accordance with its business plan.

Under my proposal, board decisions would continue to be protected by the business judgment rule. That would mean that directors would continue to be protected in deciding how to achieve long-term profitability under the business plan, as well as how to allocate profits among the various corporate constituents. But clarifying that fiduciary duties are mandatorily long-term in nature outside of the takeover context would force directors to conduct analyses (in compliance with their duty of care) that would enable them to decide whether each business decision would be primarily beneficial to the corporation and the stockholders in the long-term—and their failure to do so could amount to a conscious disregard of their duties and thus an act in bad faith. This, then, could lead to a breach of the duty of loyalty. That would likely mean that directors would have to increasingly consider nonfinancial factors in making decisions, for the long-term often cannot be summed up in a neat financial calculation. But the challenge of valuing the long-term effects of corporate decisions should not preclude their primary importance.

Because this reformulated duty would only require directors to primarily act in the long-term best interest of stockholders and the corporation, directors could, in compliance with this duty, consider the interests of short-term stockholders in making business decisions. This would give directors some flexibility in making business decisions that are intended to deliver short-term profits. However, it would not permit them to place those short-term interests above, or even on par with, the interests of stockholders and other corporate constituents in sustained corporate profitability. Because stockholder and non-stockholder constituents' interests converge in the long-term, this interpretation would also seem to more faithfully implement the longstanding construction of directors' fiduciary duties, which require that directors consider the interests of stockholders as well as the interest of the corporation.

One may ask why the board—rather than some other constituent—should as an initial matter be charged with implementing the corporate purpose of long-term profitability. For one, the board is the body that oversees adoption and implementation of a corporation's business plan. The business plan is the source of the corporation's long-term profit-making strategy. Thus it makes sense for the board to be charged with implementing the corporate purpose through its oversight of the business planning process. The fact that boards are generally composed of highly respected and knowledgeable businessmen and women would only make discussions about long-term profit-making strategies more meaningful. Moreover, the board is already charged with the duty to act in the best interest of the corporation and its stockholders under its fiduciary duties. To the extent that any constraints are imposed on what amounts to the best interest of the corporation and stockholders, they would necessarily need to be reflected through a modification to those fiduciary duties. And this proposal would be consistent with the notion from *Revlon* that any temporal limit on directors' discretion in making business decisions should be imposed on directors through their fiduciary duties.

A related question pertains to why the common law of fiduciary duties—rather than legislation—is the appropriate means to implement a long-term corporate agenda. Initially it is important to note that my proposal does not purport to "fix" in its entirety the "problem" of short-termism. There are undoubtedly complementary steps that could—and should—be taken to shift the focus of corporations toward long-term profitability. But my proposal is intended to be the first guiding step down that path, for it would seem backward to implement a long-term policy objective through spe-

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cific legislative or regulatory changes before that policy objective is manifested through corporate governance standards. Moreover, given the limitless ways in which corporations can achieve long-term profitability in light of their unique business structures and strategies, it seems to make sense to use, at least as an initial matter, the standards-based approach offered by fiduciary duties to implement the long-term mandate rather than a narrower, rules-based approach typically associated with legislation. This change would also ensure that state law regulating internal affairs remains relevant in the current environment of short-term investor activism. However, once my proposal is implemented, in my view it would then make sense to consider targeted ways—for example through tax incentives or penalties, new disclosure rules, or changes to the corporate voting mechanism—to implement the then-clear corporate objective of generating sustainable profits, at all times being sensitive to the welcome differences between corporations and the ways in which they may achieve that objective.

This reinterpretation of the corporate purpose would also provide directors with much-needed guidance as to how to discharge their fiduciary duties, particularly in an era where they are faced with pressures from executives as well as from investors to make decisions that generate short-term profits. As the Delaware Supreme Court has acknowledged, one of the objectives of Delaware fiduciary duty law is to provide directors with "clear signal beacons and brightly lined channel markers as they navigate with due care, good faith, and loyalty on behalf of a Delaware corporation and its shareholders." This proposal would in fact provide some clarity as to what corporate purposes directors must seek to achieve. This, in turn, should enhance accountability of directors to shareholders, for removing an element of discretion from the board gives shareholders a more clearly defined standard to which to hold directors accountable. And since the reformulated duty would lead directors to act in the interest of both shareholders and the corporation, shareholders (at least long-term shareholders) would indeed serve as a proxy for the corporation in enforcing this duty, for doing so would be in the interest of both.

Still, this reformulation of fiduciary duties would not apply in all contexts. Specifically, because the reformulated duty would require directors to consider how to maximize profits under the corporation's long-term strategy, it would not apply in the context where the board was faced with a potential takeover or other similar sale transaction in which the future of the corporation was being questioned. Indeed, it is in that context that the board is deciding the very question of whether or not to scrap the corporation's long-term strategy in favor of a sale. Thus in that context it makes sense to continue to permit directors to consider not only the long-term interests of stockholders and the corporation but also their short-term interests. Again, this might explain why the cases discussed elsewhere in this article give directors such broad discretion as to the temporal element of their fiduciary duties.

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That is not to turn a blind eye to the fact that the market for corporate control plays a large role in the problem of short-termism that I have identified. But it is rather to acknowledge that different aspects of the short-termism problem may require different fixes, and that my proposed fix addresses one source (though not the only source) of the short-termism problem. It also has the added benefit of approaching the short-termism problem in an incremental way, with the goal both of increasing the chances of adoption and providing an opportunity to reflect on the impact of the proposal without too many major shifts in the law at once. Thus again, my proposal might complement other legal changes that would implement a policy promoting sustainable wealth-creation.