LUISS Guido Carli
LIBERA UNIVERSITA' INTERNAZIONALE DEGLI STUDI SOCIALI

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THE LAW OF DIRECTORS' FIDUCIARY DUTIES IN U.S. CORPORATIONS: AN ECONOMIC OR IDEOLOGICAL PARADIGM?

Relatore: *Prof. Roberto Pardolesi* ***Candidata:*** *Saura Masconale*

This research investigates directors' corporate fiduciary duties in U.S. corporations, proceeding in six Parts.

In Part I, I offer the motivational background. There are multiple reasons to undertake a research of U.S. corporate fiduciary law, from historical considerations about the role of directors to philosophical reflections on "the means and ends of corporate governance." From a law and economics perspective, however, there are two primary motivations.

The first is gaining a thorough positive overview of the area of law that occupies the center stage of the American corporate governance system. Virtually all the ordinary and fundamental aspects of the corporation's existence—such as mergers and acquisitions, transactions in control, executive and non-executive compensation policies, industrial strategies, and capital structure formation—are directors' decisions. As such, they necessarily involve the application and interpretation of corporate fiduciary duties.

The second motivation for researching U.S. corporate fiduciary law is normative. Indeed, one important lesson has emerged from the 2008-2009 financial crisis: a capitalistic system driven by profit-seeking shareholders and conceived as an unregulated state of nature is not always compatible with social welfare maximization. Along this line of reasoning, several corporate scholars have recently argued that the traditional shareholder-centered paradigm of American corporate law—commonly referred to as *shareholder primacy* rule (or norm)—was partially responsible for the crisis. This paradigm hinges on the idea that corporations are profit-making entities whose interests coincide with the shareholders' interests. But as the crisis has dramatically shown, in highly leveraged corporations (e.g., banks) focusing exclusively on shareholder wealth may decrease, rather than increase, the overall social welfare. This is because shareholders, shielded by limited liability, may have distorted incentives to take

excessive risk when a corporation is highly leveraged, to the detriment of fixed claimants and potentially society as a whole.

As a normative matter, this leads to question whether directors of financial corporations should take into account the consequences that their investment decisions may displace on the overall welfare before implementing those decisions. Analogous observations can be extended to situations arising in the real sector. Consider, for example, the case of relocation decisions that increase shareholder wealth but impose externalities on the local community where the corporations operates. How should directors act upon similar circumstances? Understanding whether legal doctrines or scholarly contributions provide any definitive answer to these and similar questions is at the center of my normative investigation of directors' fiduciary duties.

In Part II, I begin the positive analysis, by discussing directors' fundamental obligations of care and loyalty as enforced by U.S. courts from the early nineteenth century to modern times. From this analysis, it emerges that the traditional approach of U.S courts has focused almost exclusively on the vertical dimension of the conflicts that corporate fiduciary rules are designed to solve: the conflict between directors and shareholders. Economically, this approach views directors as agents and shareholders as principals. Within this analytical framework, conflicts may arise because the outcome of the relationship depends on unobservable actions of the agent, who may exploit this informational asymmetry to pursue her own interest rather than the principal's best interest.

In this light, the requirement that directors act with care (i.e., accuracy, diligence, and expertise) in making business decisions can be described as the "first line of protection" the law grants shareholders as firm owners. In the same vein, the duty to inform—conceived as a corollary of the duty of care—provides the essential legal

remedy against the informational asymmetry problems affecting the relationship between shareholders and directors. Further, the duty of control—the other corollary of the duty of care—is conceived as the coordination mechanism of the relationship between executive directors, who have delegated authority over the business enterprise, and non-executive directors, who supervise the use of that authority as internal monitors.

The core fiduciary duty, however, is the duty of loyalty, which—unlike the duty of care—cannot be contractually limited or eliminated. As traditionally conceived, the duty of loyalty includes both a positive guidepost for directors' conduct and a negative obligation. According to conventional wisdom, the positive mandate of the duty requires directors to maximize shareholder value. The negative mandate, instead, requires them to refrain from self-interested conduct—including self-dealing, conflicting transactions, misappropriation or waste of corporate assets, and excessive compensation. It is self-evident that under this formulation of the duty of loyalty, there is little, if any, room for the consideration of the horizontal conflicts that may arise between shareholders and other stakeholders—including creditors, workers, and consumers. Overlooking this additional order of conflicts, the traditional judicial approach to corporate fiduciary duties grants shareholders—through the positive requirement of the duty of loyalty—a primacy over other corporate constituencies. Economically, we can say that shareholders enjoy a monopoly power over directors' decisions. Within this approach, other corporate constituencies become—both economically and legally—"third parties" whose protection is relegated to the realm of contract.

In Part III, I contextualize corporate fiduciary duties within the framework of the "ideological" debate between contractarians and communitarians. This debate is essentially centered on radically opposed views of the firm, which determine, in turn, radically opposed views of directors' fiduciary duties. Under the contractarian view of the firm as a *nexus of contracts*, directors' fiduciary obligations are conceived as

contractual in nature, legally residual, and exclusively owed to shareholders. Communitarians, instead, conceive of corporations as social institutions, advocating a corporate fiduciary system that focuses on protecting the interests of all the firm's constituents. Importantly, the debate between contractarians and communitarians has shaped the evolution of modern American corporate fiduciary duties. Hence, understanding the differences between these two theories is of fundamental importance for developing a thorough positive and normative analysis of such duties.

In Part IV, I focus on the problem of horizontal corporate conflicts, addressing the fundamental question of whether there exists an efficient theory of the beneficiary of directors' fiduciary duties in situations of conflict of interests. To this end, I critically discuss the three major law and economics models that have attempted to answer this question: (i) the contractarian-oriented *shareholder primacy model*, (ii) the communitarian-oriented *entity model*, and (iii) the more recent, *team production model*. What emerges from my research is that each of these models is more ideology-driven than economically founded. The shareholder primacy model promotes ex-ante welfare by providing contracting parties with clear parameters as concerns future corporate actions, but may come at the expense of ex-post negative externalities. The entity model and the team production model, instead, have the benefit of reducing ex-post inefficiency. However, both these models may raise ex-ante uncertainty and, ultimately, increase a corporation's cost of capital—although for different reasons and with a different level of intensity.

Similarly, the judicial elaboration of corporate fiduciary duties has failed to establish general and coherent principles to solve the problem of horizontal corporate conflicts. U.S. courts have traditionally embraced a view of the corporation as a profit oriented entity—in accordance with the shareholder primacy model. More recent judicial decisions, however, have advocated a conceptualization of the corporate enterprise as an

individual entity separated from its shareholders—more in line with the entity model. The result is that a clear judicial paradigm of the horizontal dimension of corporate fiduciary duties has yet to be elaborated. Instead, law and economics theories and legal doctrines alike reflect more a political view than an analytical approach to corporate fiduciary law.

In Part V, I discuss the most significant variant to the shareholder primacy model that has been endorsed by U.S. courts: the extension of directors' fiduciary duties to creditors. I illustrate the economic and legal arguments underpinning this variant and contextualize such arguments within the general frameworks provided by the *trust fund* doctrine and Chapter 11 of the U.S. Bankruptcy Code respectively. These legal frameworks share the common feature of restricting fiduciary duties to creditors to one specific contingency: the occurrence of insolvency. Insights from modern finance theory, however, suggest that framing what I call the "creditor variant" of corporate fiduciary law as an insolvency-based exception to shareholder primacy is undesirable. This is because the excessive risk-taking problem that justifies the attribution of fiduciary duties to creditors upon insolvency might well materialize at an earlier stage of the corporate existence, as long as a corporation is highly leveraged. Chancellor Allen's famous decision in the 1991 case of *Credit Lyonnais Bank Netherland v. Pathe Communications Corp.* provides a vivid illustration of this argument.

Finally, in Part VI, I conclude supporting the view that a corporate fiduciary paradigm centered on shareholder primacy may prove ex-post inefficient to maximize social welfare. At the same time, communitarian models are unpractical to administer and create ex-ante uncertainty. Future research should move past these paradigms and focus on identifying analytical parameters of directors' conduct that can efficiently address both horizontal and vertical corporate conflicts. My attempt to move ahead in this direction is a proposal for implementing a system of "state-contingent fiduciary

duties." Under this system, corporate fiduciary duties would be attributed to different beneficiaries based on a taxonomy of court-defined corporate situations. In a sense, the creditor variant already adheres to this paradigm, providing that directors of insolvent corporations owe fiduciary duties to creditors. *Credit Lyonnais* moved further along this line, suggesting that fiduciary duties may shift to creditors "in the vicinity of insolvency" and, potentially, even in solvent corporations. Forging ahead in the same direction, I suggest that courts should, for example, devise special rules for banks. This is because banks represent a corporate context in which the traditional shareholder-centered paradigm is statistically more likely to produce inefficient results.

A last caveat is in order. It is obvious that the question of how my proposal for reform should be implemented is complex and open-ended. What is the optimal set of special corporate contexts courts should focus on? How should courts select one context over another? These are only two of the additional questions that would need to be addressed under the state-contingent fiduciary duty system I propose. It is important to emphasize, however, that experience would help to answer these questions. Over time, courts would gain statistical insights on fiduciary schemes that have proven successful and be able to amend those that have not, promoting more efficient corporate relationships.