A Contractual Approach to the Regulation of Corporate Directors' Fiduciary Duties

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Abstract

Traditional American corporation statutes state that the business and affairs of the corporation shall be managed by a board of directors who act as fiduciaries of the corporation. The purpose of this paper is to explain the economic logic underlying the regulation of corporate directors' fiduciary duties, placing special emphasis on the consequences of the adoption of protective measures for the directors such as indemnification and liability insurance.

Keywords: corporate governance; corporate directors; fiduciary duties.

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1 Introduction

Traditional American corporation statutes state that the business and affairs of the corporation shall be managed by a board of directors who act as fiduciaries of the corporation. The purpose of this paper is to explain the economic logic underlying the regulation of corporate directors' fiduciary duties, placing special emphasis on the consequences of the adoption of protective measures for the directors such as indemnification and liability insurance.

Easterbrook and Fischel (1991) have discussed the economic structure of corporate law.[1] They have put forward a contractual view of corporate law that interprets legal rules about corporate matters as an attempt to fill in the gaps that must be present in complex economic contracts. The assumption underlying this contractual view is that the agents that enter into an economic contract act rationally trying to maximize their respective utilities but that due to the existence of asymmetric information and high transaction costs the agents are unable to write a contract that completely specifies their respective rights and obligations in every state of the world that may occur. Corporate law then acts as a supplement of the contracts written by the agents by establishing the rules and procedures that will be used to solve the disputes that may arise between the agents in relation to the contract. Following this line of research I study the adequacy of the regulation of corporate directors' fiduciary duties to the shareholders and the directors of the modern corporation.

In the first part of the paper I define the corporate directors' fiduciary

[1] Other papers that study the economic principles of different aspects of corporate law are Lowenstein (1998), Khanna (1996), Easterbrook et al. (1993), and Skyes (1988).

duties as the duties of the directors towards the shareholders. Given this definition, the obvious question is why there are special duties towards the shareholders and, given their highly abstract nature, how can its fulfillment be judged in practice.

In the second part of the paper I analyze the procedural regulation of fiduciary duties. Here the interest lies in determining how the different procedural norms alter the incentives of the plaintiffs to initiate legal proceedings. Ideally, the procedural regulation should foster the filing of meritorious suits and prevent the filing of frivolous suits.

Finally, in the third part of the paper I study the regulation of the protective measures that the shareholders can adopt to protect the directors from sanctions for breaches of their fiduciary duties. The adoption of these measures allows the shareholders to dissociate the preventive and compensatory functions of the fiduciary duties and to adapt the regulation to the particular characteristics of the corporation or its directors.

Some of the questions that are addressed throughout the paper are: should corporate directors be allowed to take into account the interests of parties other than the shareholders when making business decisions?, should courts refrain from judging the fairness of business deals?, should punitive damages be awarded for breaches of fiduciary duties?, why would shareholders be willing to indemnify corporate directors for breaches of these duties?, what is the role of liability insurance companies?.

The paper is organized as follows: Section 2 briefly defines fiduciary duties, Section 3 summarizes and analyzes their regulation and Section 4 ex-

plains the economic role of protective measures. Section 5 concludes.[2]

2 Legal responsibilities of corporate directors

The actions undertaken by corporate directors in their capacity as such may cause damage to different parties both inside and outside the company such as shareholders, debtholders, workers, customers, suppliers, competitors, etc. These actions can give rise to two different types of responsibility: responsibility towards shareholders and responsibility towards any other party.

2.1 Responsibilities towards shareholders

Directors owe fiduciary duties to the corporation. These duties can be summarized in the *duty of loyalty* in pursuit of the objective of maximizing profits and a *duty of care* in performance of the tasks necessary to achieve the objective. More specifically the duty of loyalty requires the director to "act in good faith in the best interest of the corporation"[3], while the duty of care requires that the director exerts "the degree of care and diligence which an ordinarily prudent director could reasonably be expected to exercise in a similar situation" (Branson, 1993, p.251).

The best interest of the corporation must be interpreted as the best inter-

[2] I do not attempt to cover all the different State Codes. The regulation discussed throughout the paper is the Delaware state corporate and case law. Delaware is the state that deals with most of the cases of derivative litigation in the US and it is considered as the leading state in corporate law. Branson (1993) reports that the Delaware Supreme Court issues more of 85% of the opinions dealing with aspects of derivative litigation in the US. For a comprehensive study of corporate law and the differences in the State Codes see Branson (1993) and Soderquist et al. (1997).

[3] The legal term "good faith" refers to the absence of an improper motive or willingness to do harm.

est of its shareholders. These fiduciary duties do not apply to other parties in the corporation such as debt investors and workers because they are a response to the specific problems of the management-shareholders relationship. Very high transaction costs and asymmetric information make it impossible to write a contract that specifies completely the obligations of directors towards shareholders as the residual claimants of the profits of the corporation. Fiduciary duties complete these contracts because: "The only promise that makes sense in such an open-ended relation is to work hard and honestly" (Easterbrook and Fischel, 1991, p.91).

2.2 Responsibilities towards third parties

When an agent of the corporation acting in his capacity as such undertakes an action that causes damage to a third party the law establishes a regime of "dual liability" in which both the corporation as a legal entity and its culpable agents, be it directors, managers or workers, share potential liability for the offenses that corporate activities inflict on third parties, so either or both of them can be held liable and be required to pay remedy (Skyes, 1988). However in practice, as we shall see in Section 4, indemnification, insurance, and the preferences of aggrieved plaintiffs to sue "deep pockets" assure that the culpable agents bear little monetary risk and are largely monitored and sanctioned inside the firm except for the most serious offenses for which indemnification may be waived and there may be imprisonment sanctions (Kraakman, 1985).

3 Regulation of fiduciary duties

The reasons why directors can be sued for a breach of fiduciary duties range from violations of laws, usurpation of corporate opportunity and unfair transactions to negligent management or improper decision making processes. Because of the highly abstract nature of fiduciary duties and the need to cover all of the different cases that may arise the regulation of these duties is very general. As we shall see, there are two very broad decision rules: the *negligence rule* for duty of care cases and the *fairness rule* in duty of loyalty cases.

3.1 The duty of care

The standard applied to a claim of a breach of the duty of care is that of negligence. This means that for a breach of the duty of care to exists there must be a damage to the corporation caused by a negligent action of the directors. Three ingredients are necessary: damage, negligence or failure to exert due care and causality. Given that the business decisions that the directors must make are always risky the responsibility for these decisions cannot be established only in relation to the result. The responsibility must be established also in relation to the effort made in the process of decision making. The duty of care has a double function. Ex-ante it has a preventive function, giving the director the necessary incentives to exercise the necessary level of care so as to reduce the probability of a damage to the corporation. Ex-post it has a compensatory function, compensating the shareholders in case the damage occurs. Taking into account the huge difference that may

exist between the damage suffered by the corporation and the wealth of the guilty director, the preventive function seems more important than the compensatory function. Since even correct decisions are subject to the risk of failure a strict liability regime -which establishes responsibility only in relation to the result- would have very limited preventive power.

Since the definition of due care is a subjective one the courts apply the so called "business judgement rule". Under the business judgement rule the director is assumed to have fulfilled his duty of care if in making a business judgement in good faith he: i) is not an interested party ii) is reasonably well informed and iii) rationally believes that the business judgement is in the best interest of the corporation (ALI, 1994). When the business judgement rule is satisfied the burden of the proof falls upon the plaintiff. If it is not satisfied the defendant will have to prove that either there is no damage or no causation.

The most cited duty of care case is Smith v. Van Gorkon.[4] A 1985 case where the Delaware Supreme Court found directors guilty of a breach of the duty of care after accepting a takeover bid for the company following a 20 minutes presentation by the CEO and after only two hours discussion on the subject. The business judgement rule was not satisfied because the directors had not informed themselves reasonably well. Other roadmap cases highlight different aspects of the business judgement rule. In Miller v. American Telephone & Telegraph Co.[5] ATT directors were held guilty because of their failure to collect an outstanding debt of $1.5 million owed to the company

[4]Smith v. Van Gorkon, 488 A.2d 858 Del. 1985.

[5]Miller v. American Telephone & Telegraph Co. 507 F.2d 759, 761-63 (3d Cir. 1974).

by the Democratic National Committee. They were not protected by the business judgement rule because they had acted in bad faith violating the federal prohibition on corporate campaign spending. In Shlensky v. Wrigley the directors of the Chicago Cubs baseball team were found innocent of charges of failure to defend the shareholders interests. The directors refused to install lights on the stadium that would allow night baseball. They argued this would deteriorate the surrounding neighborhood. The court found that this could serve the long term interests of shareholders.[6]

3.2 The duty of loyalty

A breach of the duty of loyalty exists when there is either an illicit gain for the director or a damage to the corporation caused by unfair dealing of the director with the corporation.

The existence of damage to the corporation is not necessary for a breach of the duty of loyalty to occur when the director has committed an illegal act. The courts apply this rule in cases of insider trading which typically do not imply pecuniary damages to the corporation. From an economic perspective this makes sense because in these cases there is in fact a non-measurable damage to the corporation's reputation and to the confidential relationship between directors and shareholders.

Cases of unfair dealing can be classified broadly into three categories: directors' remuneration, self-dealing transactions and usurpation of corporate opportunity. In all of these cases the director is required to place the best interests of the corporation ahead of his own interests. Because of the difficulty

[6] Shlensky v. Wrigley 237 N.E.2d 776 (Ill. App. 1968).

in judging what is in the best interest of the corporation the courts apply the "disclosure rule" and "fairness standard"; the duty of loyalty equivalents to the business judgement rule for the duty of care.

The disclosure rule is a procedural requirement. If a director has an interest in a particular transaction he should disclose his interest in the issue to the board and then a quorum of disinterested directors should vote on the issue. If these procedures are followed the burden of the proof falls upon the plaintiff. Otherwise the interested director will have to prove the fairness of the deal.

One of the problems for the application of fairness review is that the concept of fairness is an abstract one and different courts may held different criteria as to what constitutes a fair transaction. As a broad guideline the ALI Corporate Governance Project states that a deal is fair if the corporation gets at least as much as it could have obtained in an arm's length transaction. Another problem with the fairness review is whether the interests of other stakeholders should be considered.[7] Now a days, some state statutes, such as Pennsylvania and Indiana, explicitly allow directors to take the interests of employees, customers and the community into account when making business decisions. However Delaware has always opposed this trend considering that the shareholders' interest should prevail.[8] There are clear

[7] One of the most famous duty of loyalty cases is Dodge v. Ford Motor Co.,1919, Michigan Supreme Court (170N.W. 668, 684 (Mich. 1919). Henry Ford was held liable for failing to pay dividends. He claimed that all profits should be used to reduce production costs and pay higher wages. Here the court interpreted, rather narrowly, that the "best interest of the corporation" is the best interest of its shareholders.

[8] In Revlon, Inc. v. MacAndrews & Forbes Holdings the board of directors of Revlon was confronted with two takeover offers. The directors granted a lock-up option to the lower bidder because it protected the interests of debtholders. The court found them guilty for not having protected the interests of the shareholders. Revlon, Inc. v. MacAndrews

reasons for this opposition. Because the interests of other parties can be more easily protected by a simple contract, fiduciary duties should be aimed at protecting shareholders. The lack of a clear priority as to which interests should prevail would probably make all stakeholders worst off because it could result in dead-locks in decision making and in lack of accountability (Tirole, 1999).

Given the difficulties in applying the fairness review we may wonder why is it that disclosure is not required. Once again there is an economic explanation. Given the unequal negotiation powers of the director and the corporation the requirement to disclose a particular interest would result in the corporation expropriating the director from the benefit he could get in the transaction. This may explain why the most frequent duty of loyalty cases deal with usurpation of corporate opportunity and why a especial set of objective rules for fairness review have been developed in this area. As a general rule a corporate fiduciary cannot exploit an opportunity that belongs to the corporation. The problem then is to ascertain whether a particular opportunity belongs to the corporation. The courts have interpreted that a corporate opportunity belongs to the corporation when: i) the director learns about this opportunity by virtue of his position and/or ii) the director uses the corporate facilities, personnel or information to derive or develop the opportunity and/or iii) the corporation has a current or expectant interest in the opportunity (ALI, 1994).[9]

& Forbes Holdings, Inc., Supreme court of Delaware 506 A.2d 173 (1986).

[9]The most cited case dealing with corporate opportunity is Guth v. Loft 1939 Delaware Supreme Court. Loft was a manufacturer of candy and soft drinks. As Loft's president Guth was offered the option to buy the secret formula for a new soft drink. He bought the formula for himself and founded a new company, Pepsi-Cola. He was found guilty and he

3.3 The procedural forms of shareholders' actions

There are two types of lawsuits that the shareholders may interpose: personal or class actions and derivative actions.

In *personal* or *class actions* a shareholder or a group or "class" of shareholders seek personal remedy against the company. Any fines or settlements go to the shareholders who sued the company. This type of action is meant to protect minority shareholders from decisions made by or on behalf of majority shareholders. Since the company pays to the minority the balance of gains between the majority and the minority is reestablished.

In *derivative actions* a shareholder or group of shareholders seeks remedy for the corporation against directors for a breach of their fiduciary duties. By definition the directors owe their fiduciary duties to the corporation as a legal personality and not directly to any particular shareholders. Thus, in principle, the agreement to take legal action against the directors should be adopted by shareholders' in the general meeting. But, given that it is the board who calls the general meeting, directors can delay or prevent the adoption of such an agreement. Also, a group of shareholders may collude with the directors and prevent the agreement. Therefore it is desirable to allow individual shareholders to take legal action against directors. However when seeking remedy against directors the corporation must be made the nominal defendant so that the proceeds from any judgement will be equally divided between all shareholders. This type of action is meant to defend shareholders as a group against directors and it is the directors who pay the remedy that goes to the corporation. Hence when talking about directors

had to turn over the company to Loft.

responsibilities to shareholders we are concerned with derivative actions.

3.4 Procedural regulation of derivative actions

The decision to sue is usually based on observable things like the corporation's performance and the decisions of the board, but also on the procedural rules. Rules about legal fees, settlements and award of punitive damages alter the parties incentives to litigate. The regulation of derivative actions can be understood as an attempt to facilitate the filing of meritorious actions, as a means to improve corporate governance, while at the same time preventing the filing of frivolous lawsuits that result in a waste of corporate and legal resources.

First there exists a *requirement for the corporation to pay the legal fees* of the successful plaintiffs. Otherwise may derivative actions that are beneficial for the company would never be interposed because, since the proceeds from any derivative action go to the corporation and are divided equally among all shareholders, the legal fees may well exceed the award for damages that a single shareholder or group of shareholders may expect to receive. But the requirement that the corporation pay the legal fees may also result in the pursuit of frivolous lawsuits where the expected award times the probability of obtaining a condemnatory sentence is lower than legal fees. The plaintiff however may file the action seeking the award of attorneys' fees (Lowenstein, 1998). As a matter of fact many derivative actions end up with a settlement where the plaintiff and the directors agree on some monetary or non-monetary relief such as the passing of a bylaw or code of conduct and also on the corporation paying the legal fees of the plaintiff. Many of these

are the so called "cosmetic settlements" where the directors reach an agreement in order to avoid the legal costs of a trial and there is no real benefit to the shareholders (Romano, 1991). To prevent this from happening these settlements have to be approved by the court. Lowenstein (1998) claims that the agreement to pay the fees of the plaintiff following a settlement should be approved only when there is a "substantial benefit" to the corporation.

There are two more requirements that the would-be plaintiff has to satisfy before he can initiate legal proceedings. They are discussed below.

To prevent the pursuit of frivolous lawsuits and as a measure of legal economy the law also establishes a second requirement: *the requirement of demand upon the board to take proceedings on behalf of the corporation* before the filling of a derivative action. This requirement can only be omitted if it is proved that the majority of directors are an interested party or that a delay in legal action could result in irreparable damage to the corporation.[10] When the demand is made the corporation can set up a special litigation committee of disinterested directors that will decide if the demand is accepted or rejected. If it is accepted the company itself will file the lawsuit, if it is rejected and the shareholder who made the demand still wants to proceed he will first have to prove that the committee decision did not satisfy the business judgement rule (Branson, 1993).

Some states like New York and California have also a *security for expenses*

[10] In Aronson v. Lewis a 47% shareholder and director was awarded generous bonus and consulting arrangement. The plaintiff brought action against him without making a previous demand upon the board which he considered was dominated by the majority shareholder. The Supreme Court of Delaware considered demand could not be excused and dismissed accusations of domination because the majority shareholder owned less than 50% of the shares. Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

statute. The plaintiff can be asked by the court to give security for the defendants reasonable costs in case the plaintiff losses. Delaware has always opposed to this statute because of its non-discriminatory character that can prevent both meritorious and frivolous cases from being filed (Soderquist et al., 1997).

If the defendant is found guilty he is sentenced to pay damages to the corporation. Some courts also award punitive damages in excess of the loss suffered by the corporation, however Delaware courts have never awarded punitive damages. It can be argued that a higher expected penalty leads to a general increase in care and loyalty (P'ng, 1987; Polinsky, 1991). However, if one adopts a contractual view of fiduciary duties, the posture of Delaware becomes clear. Since fiduciary duties are meant to complete contracts the court should not try to impose any "desirable" standard of care. It should rather try to enforce the standard agreed by the parties on the contract. The requirement to exert a higher level of care has to be compensated with additional remuneration, so that the contract that the shareholders offer to the director (given the potential awards that the director will have to pay if he is found guilty of a breach of the duty of care) is individually rational for the director. Therefore the attempts to raise the standard of care by awarding punitive damages can be very costly. The value of the firm to its shareholders will decrease if the decrease in the probability of suffering a loss is not enough to compensate for the higher remuneration that the risk averse director will demand.[11]

[11] Polinsky and Shavell (1997) and Karpoff and Lott (1998) present two different views on the general debate about punitive damages in corporate law. Polinsky and Shavell (1997) suggest that punitive damages should be used when the probability of detection is small

4 Protective measures: Indemnification, D&O Insurance and LLPs.

Fiduciary duties make directors subject to financial risks since they will be required to pay a damages award to the corporation when found guilty of a breach of duty. These risks are meant to act both as an ex-ante deterrence incentive to prevent breaches of fiduciary duties and as an ex-post compensatory mechanism for shareholders when the director does not comply with his duties. Indemnification, insurance and any other type of provisions that shift those risks from directors to other parties will interfere with these deterrence and compensatory functions.

4.1 Conflicting views on protective measures

In the US directors are frequently sued and shareholders the most frequent class of claimants with 40% of lawsuits. However, at the same time, liability insurance is widely used: over 90% of Fortune 1000 company directors are covered by a directors' and officers' liability (D&O) insurance that the corporation buys on behalf of its officers and directors (Louis Harris and Associates, 1995).[12]

The liability insurance crisis during the late eighties started the debate

to make sure that potential defendants internalize the potential damages imposed upon others. Karpoff and Lott (1998) argue that punitive awards are costly to firms because they are highly variable and unpredictible. They maintain that where a contractual relationship exists reputational mechanisms can achieve the same level of prevention activity at a lower cost. Notice that reputational mechanisms are likely to be important in the director-shareholders' contractual relationship where there are long term contracts.

[12] Many different professionals, such as doctors or architects, are protected by a liability insurance policy. Shavell (2000) summarizes the effects of this type of policy. What makes the case of corporate directors particularly interesting is that in their case it is the shareholders who buy the policy on behalf of the directors of the corporation.

over the adequacy of indemnification and D&O insurance.[13] The coincidence in time of the crisis with increases in directors wages and the adoption of golden parachutes and anti-takeover measures lead some to consider the demand for D&O insurance as a sign of managerial entrenchment. The argument is that protective measures interfere with the disciplinary and compensatory functions of fiduciary responsibility and allow directors to insulate themselves from courts supervision and avoid accountability for their actions (Bishop, 1981). In fact this is the argument of the German legislature for forbidding D&O insurance and it may explain why it is rarely used in continental Europe.

However, forbidding liability insurance may not be in the best interest of shareholders. The premise of the contractual view of fiduciary duties is that the role of fiduciary duties is to fill gaps in contracts. Therefore the courts should allow the parties agreements to override the legal rules. Bhagat and Brickley (1987) and Brook and Rao (1994) present empirical evidence that indicates that protective measures for corporate directors seem to increase shareholders wealth. They defend the view that when directors are risk averse some type of protection is desirable. Otherwise their decisions could be distorted towards reduction of risks and they may be to conservative in the management of the corporation. There are two problems with this argument. First, there exist other mechanisms to induce the directors to take risks that do not limit their accountability, such as performance contingent

[13]During the eighties both the number of lawsuits against corporate boards and the costs of defense and fines of these lawsuits increased dramatically. Most of the claims where related to takeovers, IPOs and business failures. The response of the D&O insurers was a huge increase in premiums and limitation of coverage for the corporations that were able to afford the premiums (Romano, 1991; Winter, 1991).

remuneration. Second, they do not explain why directors should only be sued for adopting risky decisions and not for adopting conservative ones.

4.2 The regulation of protective measures: definition, applicability and limitations

There are three different mechanisms through which the corporation can shift the legal risk that its directors face: indemnification, liability insurance and limited liability provisions. The general use of all of these options in combination already suggests that they are complements and not substitutes.

Indemnification provisions shift the financial risk from the director to the corporation. As a general rule the director is entitled to indemnification from the corporation for expenses, damages, fines and amounts paid in settlements incurred in the performance of authorized duties. This covers all third parties lawsuits even if the is found guilty as long as the directors acted in good faith in the best interests of the corporation and did not obtain an improper personal benefit. Some US states such as Delaware and New York also allow for indemnification of amounts paid for expenses in derivative actions when the director is found innocent but never when he is found guilty. Sometimes the possibility of indemnification depends on the decision made by the board or shareholders (Mattar and Hilson, 1979).

Liability insurance differs from indemnification in that it shifts risks from the director to a third party, the insurance company, rather than to the corporation. In a typical insurance policy the insurance company agrees to pay on behalf of the director the losses resulting from claims against the

director for wrongful acts in his capacity as a director.[14] The insurance policy can cover all the cases that indemnification may cover but what is special about insurance is that it extends to cover damages, fines and amounts paid in settlements in derivative actions when the director is found guilty. The only exceptions are again cases where the director acted in bad faith or obtained an improper personal benefit. The exemption requires not only that the director profited from the act but also that it was illegal (Mattar and Hilson, 1979).

Finally, *limited liability provisions* (LLPs) differ from both indemnification provisions and liability insurance in that they effectively eliminate the directors' personal liability for monetary damages to shareholders for breaches of the duty of care. These provisions specify cases where the director can not be sued by the shareholders. Only certain provisions allowed by the state laws may be adopted, and to be effective these provisions must be specified in the company's statutes (Brook and Rao, 1994). After the majority of American jurisdictions adopted statutes that allowed LLPs in 1996 more than 70% of large publicly held corporations amended their articles of incorporation to include these provisions. While some indemnification provisions may be mandatory, liability insurance and LLPs are always a choice of the shareholders.

[14] In 1991 the average annual premium paid for D&O coverage ranged from $366,000 for large banks to $155,000 for manufacturing firms and was unavailable for small and medium size firms. Indemnification is paid in 61% of cases, and the average defense costs are about 596000. Most cases are related either to mergers (15%) or to inadequate disclosure policies (7.7%) (Branson, 1993, pp. 802).

4.3 The economic role of protective measures

Summing up the rules for the application of the different types of protecting measures we find four different cases:

- There is a mandatory requirement for the corporation to indemnify the director for legal fees and other expenses in both third-party and derivative actions in the cases in which he has been successful.
- There are permissible indemnification statutes that allow the corporation to indemnify the director for legal fees and other expenses in third-party actions when he has been found guilty as long as he acted in good faith in the best interests of the corporation and did not obtain an improper personal benefit.
- The corporation can subscribe a D&O liability policy that covers the director for legal fees and other expenses in both third-party and derivative actions as long as there is not bad faith or improper personal benefit. The corporation can also amend its articles of incorporation to allow for LLPs that eliminate liability for breaches of the duty of care.
- Any type of indemnification, insurance or LLP protecting directors in cases of bad faith or when the director obtains an improper personal benefit is forbidden.

In what follows I will try to explain the rationale that can be found behind this complex regulation. I will deal with each of these cases separately.

4.3.1 Indemnification

The existence of mandatory indemnification when the director has been successful has a straight forward explanation. Since the corporation is risk neutral and the director can be considered risk averse optimal risk sharing implies that the corporation should bear any unexpected expenses that may occur. Motivation of the agent is not an issue because he is proven to be innocent.

In cases where the director is held liable to a third party the law establishes a regime of "dual liability" in which both the corporation and the director share liability, however it also allows the company to indemnify the director even if he is found guilty. Here again we can think of an optimal risk sharing arrangement: the director may be liable to a third person and still have acted in the best interest of the corporation. However we may wonder why does the "dual liability" regime exists in the first place.

The dual liability regime serves both a compensatory and a preventive function. The compensatory function is especially important in small closely held corporations where the corporation may go bankrupt before it can satisfy damages to third parties, the dual regime implies that the directors will be required to pay for the difference. This in turn has a preventive effect. Since the directors govern the corporation, holding them liable will prevent them from engaging the corporation in illegal actions even if they are in the best interest of the corporation (Kraakman,1985; Skyes, 1988). This explains why no indemnification is possible when the director has acted in bad faith. It also explains why indemnification is permissive in any other cases rather than mandatory. The degree of indemnification that the parties agree upon

the contract determines the standard of conduct that the shareholders can expect from the director towards third parties.

4.3.2 D&O Liability Insurance

It is less clear why shareholders would want to insure the directors for the expenses they have to pay when found guilty in a derivative action.

Given that there is a negligence standard directors that fulfil their fiduciary duties should expect to be found innocent and there is no reason why the shareholders should want to compensate a guilty director, on the contrary, the higher the punishment for misbehavior the higher the incentives to comply with fiduciary duties. However the implementation of a negligence regime is subject to legal errors where an innocent (guilty) director is found guilty (innocent). The presence of legal errors makes insurance an optimal form of remuneration for a risk averse director when the potential award for damages is large compared to the director's wage. Insurance policies usually carry deductibles and coinsurance to avoid the moral hazard problems of complete insurance.

A different question is why an insurance company is interposed in this case.[15] Some view the shareholders as insuring themselves through the purchase of a D&O liability policy (Romano, 1991). If the director's behavior causes a loss to the corporation the insurance company will pay the damages awarded. But shareholders are risk neutral and therefore they would never buy insurance priced at or above an actuarial fair price.

[15] A related question is why the directors do not buy the insurance policy themselves. There seem to be tax advantages in having the corporation buy the policy, but another reason may be the unavailability of direct liability insurance because of important moral hazard and adverse selection problems.

Holderness (1990) and Mayers and Clifford (1982) argue that insurers can have an important monitoring role by investigating the firm's past actions and setting conditions for the directors to observe before issuing a policy and serving as an investigator when an allegation of misconduct arise. Because of the exclusions in the coverage insurance policy the insurance company does investigate when coverage for a given claim is being reviewed. Although this services could be provided separately from the actual insurance Holderness (1990) argues that there are advantages to the joint provision because the insurance firm has a comparative advantage in observing and investigating actions that can give rise to liability. The fact that in many insurance policies include a duty to defend upon which the insurance company is charged with providing legal counsel for the defendant supports this view. Besides the provision of coverage gives the insurance company the incentives to investigate since it bears the wealth effects of the investigation.

Another reason why insurance may be preferred to indemnification relates to the ex-post incentives to litigate. Derivative actions are a disciplining device but given litigation costs the shareholders will only sue directors when the expected benefit outweighs these costs. If the corporation was to indemnify guilty directors shareholders would never take legal action in the first place and the directors would have no incentives to fulfill their fiduciary duties. This also explains why the typical D&O policy not only protects directors and officers from liability that can not be indemnified but also reimburses the corporation for indemnification payments.

4.3.3 LLPs

Another problem is the widespread use of LLPs. Branson (1993) contemplates LLPs as the alternative to insurance for small and medium size corporations. But LLPs seem to eliminate the disciplining effect of derivative actions. A better alternative for insurance would be to allow corporations to place caps to the amount of damages that the director should pay. In fact this alternative was proposed by the American Law Institute (ALI) in its Corporate Governance Project. However this proposal has been ignored and the states have adopted exculpation statutes.

As noted above derivative actions give directors the incentives to fulfill their fiduciary duties at the cost of making them bear the risk of possible legal errors. If incentives can be provided more effectively through the use of other type of monitoring and performance sensitive compensation the adoption of these provisions is optimal.

Besides, the adoption of LLPs can be accompanied by the adoption of procedural requirements (the set up of committees of independent directors or the appointment of independent advisors) that the directors must follow to get protection from the provisions. By doing so the corporation can give incentives to its directors to adopt a minimum level of care while, at the same time, effectively protecting them from legal errors. LLPs can implement a perfect negligence regime at the cost of a lower standard of care.

4.3.4 Prohibition of protective measures

Finally, any kind of indemnification, insurance or LLP is forbidden for the cases where the director obtained an improper personal benefit or acted in

bad faith, i.e. with an improper motive or willing to do harm or cause a loss. This basically refers to the duty of loyalty cases where the director is found guilty of pursuing his own interests rather than the best interest of the corporation.

Easterbrook et al. (1993) argue that because fiduciary duties act as complements to contracts we should expect to see more strict fiduciary duties imposed in situations where the agent cannot be provided with the incentive compensation to align his interests with those of the principal. As we have seen LLPs will be used as alternatives to the application of strict legal fiduciary duties when the desired level of care can be induced through the use of monitoring or incentive compensation at a lower cost. However, by definition, when there is a possible breach of the duty of loyalty the parties incentives are misaligned. When this situation arises it is because other preventive mechanisms have failed. Therefore shareholders would never adopt LLP that eliminate the directors' personal liability for breaches of the duty of loyalty.

Is there a role for liability insurance for breaches of the duty of loyalty? Duty of loyalty cases involve a transaction between the director and the corporation (in cases dealing with directors remuneration or self-dealing transactions such as loans or rental contracts) or between the director and a third party (in cases of insider trading and usurpation of corporate opportunity). The existence of these transactions is easily verified by the court and the problem is to determine whether they are fair. Because of the difficulty in determining the fairness of a transaction the law establishes a disclosure regime that shields interested directors from legal risks making insurance

unnecessary. A disclosure regime allows the parties to optimally negotiate transactions between the director and the corporation that where not foreseen when the initial contract was written.

This leaves us with the cases of transactions between the director and third parties for which disclosure is not a viable option and the courts apply the fairness standard. The effect of a liability insurance would be to induce the director to undertake any transaction with a expected benefit higher than his potential liability. Therefore in the case of illegal actions such as insider trading insurance should not be allowed. In cases of appropriation of business opportunities the shareholders could benefit from buying liability insurance and allowing the director to pursuit those transactions by agreeing on a lower remuneration level. However this possibility is highly unlikely because the appearance of a business opportunity can not be foreseen ex-ante and therefore the costs of contracting on it are very high. Therefore the parties will not contract on these opportunities and no insurance will be provided. This does not make directors subject to high legal risks since risk-averse directors can shield themselves from legal risks by not entering into these transactions.

5 Conclusion

Easterbrook and Fischel (1991) interpret corporate law as an attempt to complete economic contracts in an optimal way, supplying the rules that the parties would agree upon if they could write complete contracts. In this sense fiduciary duties are meant to fill in the gaps in the contracts between directors and shareholders.

Following this rationale we should expect legal rules about fiduciary duties to be unambiguous enough to offer protection against unforeseen contingencies but also flexible enough to allow parties to contract around them and to reflect the changes in typical contracts. The economic analysis conducted in this paper shows that the existing regulation is an attempt to reconcile these conflicting requirements. On the one hand, decision rules such as the "business judgement rule" and the "fairness standard" are attempts to offer objective judgement rules that can be applied in any unforeseen contingency. On the other hand, the possibility of adopting protective measures such as liability insurance and LLPs gives the shareholders the necessary flexibility to adapt the existing regulation to the particular characteristics of each corporation.

The regulation of fiduciary duties is now faced with the need to accommodate the new views about corporate directors' mission in governance. With regard to the duty of care, the new codes of conduct for corporate directors do no longer regard directors as the managers of the business and affairs of the corporation but as monitors of the management team.[16] As the management of the business is moved away from the board to the management team the duty of care should also move away from the directors to the executives. However the board of directors should always retain a duty of care in monitoring. As for the duty of loyalty a question open for debate is to what

[16] For example the ALI (American Law Institute) Corporate Governance Project states that "Management of the business... shall be conducted by or under the supervision of such senior executives as are designated by the board of directors.... The role of the board of directors is that of monitoring in its sense of general observation and oversight, not active supervision or day-to-day scrutiny. The board has to select, regularly evaluate, fix the compensation of, and, where appropriate, replace the principal senior executives."

extent should the interests of stakeholders other than shareholders be taken into account. While a recognition of the corporation's social responsibilities seems necessary the rules should be clear enough to prevent deadlocks in decision making and lack of accountability.

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