Lecture

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LIABILITY AND ACCOUNTABILITY: THE KEY FOR CORPORATE GOVERNANCE

Gustavo Visentini

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INTRODUCTION

There may be two ways to deal with this issue of liability and accountability of company directors: one is to describe the positive law (*e.g.* Italian law); the other is to try and catch the principles concerning the issue looking at history and at comparisons, so that the actual problems underlying the various solutions adopted by national legislators may be better appreciated and understood. I am choosing to deal with the issue following this latter model.

In this talk, I am going to discuss not just the civil liability attaching to a breach of directors' duties and the consequent liability for damages which ensues, but also the issue of accountability for business judgment, that is the case where the exercise by a director of his discretion has been judged unfavorably and this leads to his dismissal. These issues imply fundamental questions of corporate governance.

According to the traditional view (the so called contract theory) a director is a fiduciary of the shareholder.

We can divide the following discussion into three parts:

- A brief discussion of the nature of the fiduciary's duties to his principal. The fiduciary relationship is at the heart of organizational forms, from the simplest, like agency, to the most complex of institutions.

- In reviewing the nature of these relationships in the context of corporations, we can also identify the differences in corporate structure in financial systems that are driven by the banking system and those which are driven by the State.

- Finally, I shall recall the other main theories of the corporation (the so called institutional theory, stakeholder theory, obsolescence of the fiduciary obligation) which lead to different interpretations of the nature of the responsibilities of directors and of corporate governance itself.

Different doctrines and legal opinions provide the conceptual framework for the different realities dealt with by positive law. Comparison is fundamental inasmuch as it allows to verify their effectiveness, having regard to the quality of governance.

I

THE FIDUCIARY DUTY

In the fiduciary relationship, the fiduciary is encharged with the management of the principal's interests; this means the fiduciary will engage in acts which will bind his principal. The fiduciary's acts are the result of discretionary (independent) voluntary decisions made by the fiduciary himself and it is this activity which the fiduciary promises to perform in favor of the principal. The appointment may be for a specific transaction or for the general management of the affairs of the principal.

Take the example of a situation where I engage someone as a fiduciary to buy a residential apartment in New York for my account which I want to be a good investment. I also ask him to improve on my investment so that it increases in value and gives me a rental income. By accepting this mandate, the fiduciary promises to make decisions on my behalf in relation to the acquisition and to the subsequent management of my investment. In this regard he does not just act as a business intermediary who limits himself to choosing which deal to bring to his principal's notice and to merely carrying out negotiations on his behalf. Rather, he negotiates and completes the purchase himself and in doing so he binds the principal. He does not act as a mere *nuncius* with no power to decide whether to buy an apartment or not and with only the limited power to make payment or perhaps perform the deal pursuant to specific instructions. Indeed, when conferring the fiduciary mandate, the principal expressly relies on the fiduciary's capacity to evaluate the business and on the fiduciary's management qualities. The standards required in the performance of the mandate do not relate only to a duty of care owed to the principal in the execution of his instructions but to standards which relate to the very exercise of the fiduciary discretion itself.

1.1. Remedies

Remedies for breach of fiduciary duty have to be adequate to ensure that the decisions of the fiduciary will be consistent with the interests of the principal. Ultimately, the strength of the fiduciary duty depends on the effectiveness of the remedies available. Nonetheless, the remedy damages is only one of the two ways in which the effectiveness of the fiduciary duty is ensured: the right to terminate the fiduciary mandate is the ultimate sanction enabling control of the fiduciary by the principal.

One possible remedy is the payment of damages, in case fiduciary violates his duties; but also, another remedy is the termination of his mandate by the principal.

1.2. Liability for damages

In essence, given the typical characteristics of the fiduciary duty, the remedies for breach serve largely to guarantee the impartiality of the fiduciary and to avoid conflicts of interest. This supplements the protection afforded by the right of termination which remains the main sanction allowing effective control by the principal over how the fiduciary exercises his discretion.

The fiduciary has a duty of care to exercise his discretion as a reasonable man or, depending on the circumstances and on the nature of the mandate, according to the standard of care which is expected for a professional. The concept of “due care” is the general requirement applied to the performance of any obligation or duty. The specific nature and content of the standard of care to be shown by the fiduciary will vary according to the characteristics of the performance required. These standards are objectively known to the community of interest holders. They are grounds for claims against the fiduciary for negligence or non performance.

In exercising his discretion on behalf of the principal, the fiduciary is, by definition, completely free to act within the terms of his mandate. The wider his mandate, the wider his discretionary powers. It is obvious that the granting of discretion avoids fixed and rigid rules (or standards) which may limit its exercise. If I rely on the professional capacity of someone to whom I confer money to invest in the stock market on my behalf, my intention is to rely on his capacity to judge the market. The standards to apply to the exercise of his judgment are not those which relate to standards of mere execution; rather, such standards relate to the manner in which he exercises his discretion. For example, the fiduciary to whom the principal gives his money to manage and invest must fully understand the needs of the principal, inform himself of the various options available in the exercise of his duties, and know when to it is appropriate for him to inform his principal and obtain specific instructions.

In other words the standards apply not to *what* the fiduciary decides but to *how* he decides.

Within the standards of due care, we can also include the duty of loyalty. According to the dictionary, “loyalty” is a moral commitment having the characteristics of independence, rigor, reliability and impartiality. Hence, the fiduciary needs to be impartial. He therefore makes his decisions only where no other interest – either his, own, or of third parties – can affect his judgment. If the fiduciary is subject to conflict, he must then inform the principal to permit him to decide whether to continue or terminate the mandate.

The duty of loyalty specifically characterizes the fiduciary relationship. Hence, the fiduciary must not be in conflict of interest. Take the example of a mandate given to a painter to paint an apartment. The painter decides how he will organize the work and he is bound to perform the job according to a proper standard. However, he makes no decision on behalf of the owner of the apartment, for it is the owner alone who decides whether or not to repaint the apartment and it is the owner who hires the painter that will do the job. Once hired, the painter is subject to a duty of good faith in the performance of the painting task but not to a duty of loyalty: he can, in fact, ask his son to help him without being in conflict of interest. This is clearly different from the case where I ask the painter to choose and hire a plumber to re-do the plumbing, that is, not merely to suggest someone, but to actually hire a plumber on my behalf.

The principal has to prove that the fiduciary was negligent in exercising his discretion when this causes damage. The more the principal relies on the fiduciary’s business judgment, the harder it will be for him to establish negligence. On the other hand, in order to prove a breach of the duty of loyalty, the principal only needs to prove the existence of the conflict of interest and this will be cause for terminating the fiduciary mandate, and then to a claim for damages, if they can be proved.

Any claim for damages must be proved. Where the fiduciary has exercised his duties with regard to his personal interests, it is difficult to establish damage in accordance with the traditional parameters of *lucrum cessans* and *damnum emergens*. For this reason, some jurisdictions not only adopt a wide concept of what may be a conflict of interests but also presume that any gain received by the fiduciary is in breach of his duty unless he can prove that such gains were not connected with, or that they were independent of, any of the affairs that he managed on behalf of the principal.

Given the difficulty of establishing the damage actually caused by the fiduciary in conflict, the law often sanctions the disloyal conduct by other means, for example, through provisions of the criminal code or by establishing provisions that make it generally incompatible for certain people to assume a fiduciary position.

1.3. Terminating the mandate

Termination is the ultimate remedy available to the principal in his sole discretion. Termination does not necessarily sanction non performance. It derives from the personal evaluation that may be made by the principal with respect to what he considers to be the proper policy in pursuit of his personal interests, whereas such proper policy is not shared, or pursued, by the fiduciary.

In order to ensure that the principal may effectively decide upon the use of the remedy, the fiduciary has a duty to keep the principal informed and to disclose the actions undertaken. How often information must be given is a condition provided for in continuous fiduciary relationships.

1.4. The principal in the fiduciary relationship

I have discussed the fiduciary relationship in which the beneficiary exercises the prerogatives of the principal. Agency is an example. There are instances, however, where the duties owed by the fiduciary are identified by the law or a private document creating a fiduciary relationship in relation to the management of the private affairs of an individual who, because of legal or actual incapacity, is not able to exercise normal prerogatives. An example of this is the case of a guardian managing the affairs of a minor (e.g. a father acting in the best interest of the minor). Should the guardian (father) not act in the best interest of the minor, it is the law that creates devices permitting control of the fiduciary's performance, such as the public official (a specialized judge). This control is necessary otherwise the proper performance of the fiduciary's responsibilities will not be ensured The fiduciary may act without any sense of responsibility since he is not risking any of his own assets, he is risking the beneficiary's assets.

Similar mechanisms can be seen at work in complex organizations. In a legally recognized association of persons, the participants themselves can exercise the prerogatives of principals. In non-incorporated associations and trusts, where there are no participants as such, the fiduciary responsibilities of managers are monitored in accordance with specific regulations. These regulations sometimes substitute for and, at other times, supplement the due control by the beneficiaries (e.g. public charities or museum trusts).

The company by shares represents a kind of complex organizations that we will now deal with in greater details.

II

TRADITIONALLY THE DIRECTOR IS A FIDUCIARY OF SHAREHOLDERS

According to traditional model, a company director is a fiduciary of the company and owes a duty to the shareholders in accordance with his mandate. This model derives from the experience of the English company which originally was the means by which savings were collected from the public and then invested. At the time banks were not able to provide such amounts of financial resources**.**

This model was taken up in Italy in 1882 and again in the civil code in 1942. It is the model generally referred to in text books.

2.1. The traditional model

Shareholders risk their capital, appoint the Board of Directors in a General Meeting and have the power to terminate its appointment. The Board of Directors is responsible to the General Meeting and manages the company as a Board or through one of their members (the managing director) who is given specific delegated powers.

A director's duty is fiduciary in nature. Termination of his mandate is the main remedy available to aggrieved parties. His duty does not limit itself to a mere duty of diligence. While a director's duty to bondholders is limited to the exercise of diligence in relation to the payment of the debt (which is the essential interest of the bondholders), his duty to shareholders is to exercise his discretion in such a manner as to decide what the best investment is in order to generate profits. It is not limited to a duty of diligence, breach of which will expose him to a claim to damages. As a fiduciary he is expected to use his business judgment and evaluate risks, which of course subjects him to general evaluation in the appropriate forum. At the time of approving the corporate financial statements, the General Meeting will evaluate whether he has performed in the interest of the company. If they feel that he has not, then they can revoke his mandate. Recourse to a claim in damages is an action which comes later in time and is a limited one. A claim for damages may only be made if there has been a breach of duty at general law, pursuant to specific legislation or where there has been a conflict of interest. The possibility of residual actions based on a claim in negligence will hinge on the procedures for decision-making created in relation to different degrees of risk, and the degree to which the director actually participated in the decision under review.

Information regarding the exercise of the directors' discretion (necessary information in an action for termination or for damages) can be found in the financial statements of the company and in the documentation relating to actual decisions. The sufficiency, reliability and appropriateness of this information are attested to by internal and external auditors, perhaps with explanatory notes.

2.2. The effectiveness of the fiduciary duty in legislation

The strength of the rules requiring the proper exercise of fiduciary duties will depend on existing procedures for appointment and termination of appointments, the nature of claims for damages, the rules governing conflicts of interest, the quality of information available and of accounting controls. Any actions for termination, claims in damages, and, ultimately, the decisions of public savings to invest in corporate securities, will depend on these.

Existing corporate regulations offer different solutions and give different weights to the fiduciary relationship. The differences can be explained by reference to whether corporate management (and the shareholding majority in the General Meeting) or the prerogatives of the General Meeting as a whole is given greater weight (the latter case implies the protection of minority shareholders and diffuse shareholdings). The actual solution adopted is a reflection of the underlying policy of a jurisdiction, whether it conceives of the company as a contractual entity or as an institutional entity.

2.3. Exercising the vote

How voting is apportioned will determine the contractual configuration of the company. Non-voting shares do not participate in the management of the company and in particular in the appointment of directors and in the termination of such appointment. Power is thus concentrated in the hands of the shareholders holding voting shares. Normally the General Meeting deliberates specific proposals coming from the Board of Directors. Corporate governance can be quite different according to which internal rules are applied, whether they allow minority shareholders an effective voice in decision making processes or not and will depend on the nature of voting rules, quorum rules, special majorities and so on. These rules may be provided for in the charter documents of the Company.

Rules governing proxies in the General Meeting will influence outcome, especially in companies with diffuse shareholdings. Typically, directors, and the majority shareholders who support them, will be interested in collecting proxies, especially from shareholders who have made only small investments and who are generally disinterested in procedures. Where banks are allowed to collect proxies, their role is facilitated by the fact that they act as share depositories. Also banks and banking groups will generally take advantage of the voting rights accruing to the investments funds and collective investment schemes that they manage and promote (which, in Europe, is the large majority).

Similar concentration of voting power in a few hands will result from the use of cross shareholdings, pyramidal controlling structures, and voting pacts. Through voting pacts, in jurisdictions where conflicts of interest rules are weak, shareholders can virtually ensure the appointment of their selected directors. The composition of Board of Directors is thus controlled by a small group of people according to almost bureaucratic rules: it is easy to understand why the corporate ruling class has been so stable over time.

This concentration of control in certain jurisdictions like Italy is accentuated by the rule that only shareholders holding specific percentages of stock and voting powers may appeal against resolutions of the General Meeting.

The same issues apply to questions of termination.

2.4. Claims for damage

A claim for damages against corporate directors for damage to the company is an action which must be brought by the company itself and exercised through its corporate organs, that is by the same directors being sued, or, in order to avoid conflicts of interest, by the General Meeting. But even in this latter case, the action generally follows a formal proposal made by the Board of Directors. In any case the vote would need to be taken by the same General Meeting which appointed the directors in the first place. It is understandable why the action is rarely exercised since its exercise would depend on approval by the very shareholders who had voted the directors in. Moreover, in Italy it is not uncommon for directors to ask any new majority in a newly constituted General Meeting not to proceed with any actions in relation to their past performance. Although this remains an essentially moral, rather than legal commitment, in a substantially closed community it can prove to be particularly effective.

That is why it is important for shareholders to be able to make a claim against directors in the interest of the company or even in their own interest if they suffer a direct damage. The effectiveness of the derivative or direct actions that shareholders may bring against the directors will depend on the nature of the legal rules. Can a judge order that the costs of the actions be for the account of the company? Can shareholders start a class action? Do shareholders have to make demand on the company before starting a derivative suit? Are the rules of evidence in favor of the plaintiff or of the defendant? In other words is the legal system responsive and efficient in this regard?

2.5. Conflict of Interest

Reviewing conflicts of interest is an important means of monitoring directors. Impartiality in the exercise of a discretion is essential to guarantee the principal that the fiduciary acts loyally and exclusively in the best interests of the principal. In a complex context such as that of a corporation, the fiduciary should, as a matter of principle, be prevented from making decisions when in a potential conflict of interest, whether or not actual direct damage is proved. This is because in circumstances where there is a conflict of interest, damages may be hard to prove: a conflict may influence the legitimate exercise of discretion (business judgment) by the fiduciary but it is difficult to prove what, if any, loss is actually caused compared to any alternative course of action that may have been undertaken. In Italy it was once a crime for directors to vote in situations of conflict. Hence, for example, the chairman of Olivetti, who was also in Telecom, could not propose a merger between the two companies since there would have been an obvious conflict of interest in deciding the relative share exchange ratio to be adopted. This offence was subsequently removed from the criminal code and the merger went ahead.

2.6. The Board of Directors

The nature of the powers of the Board of Directors will determine the nature of the fiduciary duties of each director. The delegation of powers to the chairman or to a particular director will reduce the scope of the board’s functions to merely monitoring the legality and the merits of the management activities carried out by these officers (business judgment). In order to properly carry out this monitoring function, the board will need to be adequately structured and to have direct access to expert technical support; it would also need to be possible for each director to proceed with spot checks with the aid of experts. Many jurisdictions do not require that boards undertake this sort of activity but much less. This basically empties their function to such a point that their appointment is often made in relation to the appointment of the managing director (and in relation to the interests of the controlling shareholders) towards whom the directors feel they owe more intense loyalty than they do to the General Meeting as a whole and to minority shareholders.

2.7. Information

For market mechanisms to work, the independence of audits and of the provision of the information is an essential precondition without which minorities cannot be protected. Any real guarantee of full and proper disclosure will revolve around ensuring the standards of care that need to be demonstrated by auditors rather than on rules relating to their appointment and powers. This in turn will depend on the quality of the judicial process, proper evidentiary procedures and length of trial. A problematic issue for Italy.

2.8. The majority as fiduciary for the minority

It is the majority that controls the corporation, appoints its directors and exercises de-facto management, in a way it may be a rival or antagonistic to the minority to the extent that it has different interests. That is why, in some jurisdictions, it is sometimes implied in legislation or in developing case law that the majority may be in certain circumstances a fiduciary to the minority.

III

HISTORY OF THE TRADITIONAL MODEL

3.1. Nature of the fiduciary relationship according to the nature of the shareholding interest

Traditional analysis assumes that shareholder investments in a company are sufficiently high to render worthwhile the effort involved in enforcing the fiduciary duties of the directors. Text book analyses assume that shareholders are physical individual persons. Indeed, according to the classical "concession" theory it is assumed that a legal person cannot extend its activities beyond its stated purpose by acquiring shareholdings in other companies. While this vision of things may hold true in family based companies, it has undergone deep changes in relation to companies that manage large enterprises. The shareholding base has expanded to include the capital market and savings at large. Often, especially in the European experience, companies are participated in and controlled by other companies, by other entities, by the State, by other institutions. The diffusion of shares among the public and the changing nature of the shareholdings determines the nature of the fiduciary relationship and of corporate governance itself.

3.2. Diffuse shareholdings: the evolution of the board of directors

With the advent of widespread shareholding, the general public began to invest small amounts in companies. These small amounts were too small to stimulate interest in the day-to-day operations of the company. Their interests tended to focus on the stock exchange value of their investment, in the annual dividends, in the possibility to trade their shares. There was little interest in exercising voting rights or participating in corporate life. These shareholders would only show interest in times of serious crisis when feeling trapped inside the company they might even consider actions against directors. This situation could be taken to such an extreme that in a large company a majority shareholder (or any other relevant shareholder) might even be virtually absent and as a consequence the fiduciary role becomes evanescent.

This situation first prevailed in the United States in the 1920's and was one of the reasons leading to the creation of the SEC. The SEC monitors the market and the dissemination of information by companies, while surveillance of management activities is not within its brief. The SEC therefore assists small investors in those rights in which they are most interested: those related to trading and to actions against company directors and managers. It does not protect investors in relation to the management of the company. In this manner, it aids the small investor in those things in which he has, in fact, little capacity. This in turn means that the operation of the company is largely a matter of private law, in contrast with other situations where regulatory devices may actually become part of the governance of the company. In order to produce effective safeguards, this regulatory strategy needs to ensure the existence of competitive and independent market players and of a mass media system able to supply information, critical analysis and comprehensive market commentary.

Further development, stimulated by case law, led to the consolidation of the power of the Board of Directors and to a growing distinction between the Board and the Managing Director. The Board is the means through which shareholders monitor and control the management of the company (*business judgment*). It is responsible for this function to the extent that it has individual or collective capacities to do so or has the appropriate means to do so. For example, the Board might be held responsible in relation to a bad result on a production line only to the extent that it did not bother to investigate by using appropriate means, independently of the managing director. If the Board or a director does not investigate, then he may be liable in damages. If, on the other hand, the Board does investigate and decides not to proceed against the managing director even in the presence of an unfavorable report on the latter's activities, then the Board is exercising business judgment and the remedy is termination of their appointment. Recently, some have asserted the liability of directors for allowing the payment of inappropriate bonuses to investment bankers; in reality, this is a case of the exercise for business judgment and therefore the most appropriate remedy should be termination of appointment.

In companies with a diffuse shareholding base, where shareholders are essentially devoid of real powers of control, there has been a trend to appoint directors who are independent of management due to their vouchsafed professional experience. The current crisis has become a test for the adequacy of such solution. The specialized press, for example, has discussed the performance of the Board of Directors of investment banks which have become insolvent due to heavy losses. How can it be possible that directors, and even independent directors, did not see the danger? Certainly, had they seen the danger, the high profits shown in their balance sheets would have naturally affected their critical capacity. In addition, it must be said that many financial instruments were so complex that the risk involved were not appreciated even by those persons actually involved in their trading. For this reason it has been said that, besides having independent directors, it is necessary to set up risk management function independent of the managing director and it is also necessary to appoint directors having specific expertise (for example, expert in innovative finance).

In the past, the greater part of public savings was channeled into the stock markets through open-ended? investment funds. Reflecting the effective interests of their investors, these funds acted as if they were direct shareholders of the market, not worrying unduly about corporate matters and emphasizing trading profits and dividends. At the same time, the number of active investors in companies which closely monitor management, such as equity funds, has grown.

3.3. The nature of the financial markets determines the structure of shareholdings

The textbook model of the traditional joint stock company is predicated on a certain view of the financial markets; according to this view, businesses find their finance through direct public share and bond issues through the securities markets. For such a system to work properly both the market itself and the market players, including investment banks, need to be of a certain quality. In this model, banking intermediation is confined to short term financing, and is carried out by commercial banks. There is a clear segregation between commercial banks and the securities markets. This has been the US experience.

Prior to the first world war, the securities markets in France and in Italy also financed businesses, but following the economic crisis of the inter war years, the financial system underwent a radical change. Business finance became the preserve of the banks and the securities markets consequently withered. Instead of being in the hands of the general public, shareholdings tended to become concentrated in the hands of influential families financed by banks, financial institutions, public bodies and even the State itself. Prevailing ideologies reinforced this trend, as the economy was effectively nationalized (or if you like, “socialized”) as the banks themselves became essentially public bodies. This situation tended to continue after the war, due to the effect of the Marshall Plan which channeled funds for national reconstruction to States through their banking systems. Given the low level of savings in the economy, direct funding by businesses from the general public failed to develop. As much due to inertia as ideology (the French experience), this system has not changed to the present day, even if the general conditions of savings would have permitted a change.

3.4. Economies that are expressions of the market (and diffuse shareholding) and those which are expressions of banking intermediation (and concentrated control).

Under a different perspective, although observing the same phenomenon, one may distinguish between : (a) economies in which industry is funded through the securities markets (market-centered economies) and (b) economies where industry is funded through banks (bank-centered economies). Indeed where finance is channeled through the banks, it becomes easier for the State to intervene, participate in the economy and address the economy (the so-called “mixed” economies): the natural fragmentation of decision-making in market-centered economies certainly makes it more difficult (and, at times, impossible) for the State to really have a role in directing or influencing the economy. In this context, corporate governance reflects the nature of the economic system where it operates, by construing the nature of the shareholder and hence the relationship between the shareholder and the directors.

I shall now discuss the Italian case.

IV

THE ITALIAN EXPERIENCE

Let me first outline the main characteristics of the Italian mixed economy which contributed to industrial growth in Italy until the 1980’s and then suffocated it.

4.1. The financial system is centered on intermediation by banks

Historically, in Italy, business funding through equity issues on the stock exchange or securities markets is supplementary to banking finance. In terms of taxation, it is more onerous for businesses to fund themselves through direct securities issues than it is to fund themselves from bank intermediaries. Banks in turn fund themselves issuing securities (thus intermediating the market) and use the proceeds to finance businesses with loans. They also benefit from an implicit State solvency guarantee and by a favorable tax treatment. Bank financing is generated by banks collecting funds in the short term and lending short term; by banks issuing debt securities and lending medium term, also authorized to hold shareholdings in other companies and advance subsidized funding on behalf of the State. In this period, Italian banking entities and large businesses are for the greatest part public entities (State or local) or are controlled by public entities and are subject to intense governmental and administrative oversight.

4.2. Publicly controlled corporations and private companies

At that time, the major Italian joint stock companies could be divided into two major groups: companies participated by state holding companies such as IRI, and companies controlled by private individuals or families, like Fiat and Pirelli. State participated companies were financed through shareholdings (risk capital) and medium-term funding from state backed entities. The privately owned companies were funded by participating family interests (risk capital) and by a minority shareholder, Mediobanca, a special credit institution controlled by IRI which arranged medium term bond issues. The internal governance of these companies reflected this situation.

The directors of State participated companies owed a fiduciary duty to the controlling shareholder, IRI. IRI made sure that the internal organization of the company in which it had controlling interests reflected this situation. In turn IRI was organized as public entity subject to administrative law which laid down the rules of internal governance and which made IRI’s Chairman and officers accountable to the Government. Private shareholders in State participated companies looked at IRI to protect their interests. Over time, it became evident that these private shareholders turned to IRI rather than to the directors of the relevant company in order to promote their interests within state participated corporations.

On the other hand, the directors of privately controlled companies (non State) found that their shareholders of reference tended to be the family interests detaining control, of which they themselves often formed part. Consequently, these directors were accountable to the family, as in a small private limited company, and faced similar issues. The difference was that shareholding in large companies was more diffuse than in a private limited company and included diffuse public shareholding.

In the majority of cases, Mediobanca was a minority shareholder. Mediobanca exercised a decisive influence on the financing of the company: debt financing offered by Mediobanca was generally accompanied by an equity participation, although quite limited, and by the granting of the right to appoint at least one member of the Board of directors. This credit institution had the means of exercising influence not just as a minority shareholder but also as a creditor. The diffuse shareholding component of the company saw in Mediobanca the shareholder of reference which was in a position to represent their interests and the proper performance by directors of their fiduciary duties. Mediobanca exercised this prerogative of control through an economic *network* system of informal relationships (*salotto buono*). Although Mediobanca's management was formally accountable to IRI, in reality, the Managing Director referred directly , albeit unofficially, to the Bank of Italy and to the Government. Under the Managing Director Dr. Cuccia, this system seemed to work in an ethical manner, even though it was subject to some criticism for its tendency to favor Mediobanca's interests as a creditor and quash innovation and risk taking on the part of companies.

Family based businesses expanded after the Second World War. Their growth through the securities market was however inhibited by the limited dimensions of the stock market and they were consequently forced to turn primarily to bank financing. The nature of the Italian system as a mixed (public–private) economy hampered the growth of the Italian securities market. Although the mixed economy system may perhaps have been necessary in the post war period for the purposes of general development, it certainly then became a system which dampened the proper growth of the economy. Just as the Chairman of the Banca Commerciale, a major Italian commercial bank, had rightly foreseen at the end of the 1950's, when he advocated the creation of Mediobanca in order to stimulate the growth of the stock market, Mediobanca's role was to have been a transitional one, which of course did not turn out to be.

4.3. Recent reforms

Recent reforms of the rules applying to the financial markets and to companies occurred. They are so poor in quality and in theoretical construct that it is difficult to provide any coherent model relating to them. Nonetheless, I shall briefly discuss their impact on the nature and scope of the fiduciary relationship affecting company directors.

Even though it was championed by political voices as legislation for the privatization of the economy, and represented as such in the legislative process in the 1990's, no radical overhaul of the financial system actually took place. The system maintained the central role of the banking system, which now became concentrated into three main banking groups. These could carry out credit activity and financial intermediation as well as take up shareholdings in industrial and commercial enterprises. These groups were linked with each other through cross shareholdings, shared financial interests and voting pacts. They were also subject to the influence exercised on them by the institutional entities holding their controlling stakes, in particular by the Banking Foundations[1]. It follows that these groups were not really accountable to the market, to a shareholder of reference nor to any authority, as such, but were subject to an opaque system of cross shareholdings and control which was often external to the company itself and difficult to isolate and identify. This obscure system of control naturally influenced the management of industrial and commercial companies where the banks held shares.

[1] The Banking Foundations were created when banks were transformed from public entities into private companies. The foundations represented the institutional form (with legal personality) into which the participations in the public were converted. Part of the shareholding of the now private banks were subscribed to by the market. The foundations continued to be the shareholder of reference, even if only minority shareholders. The influence of the banking foundations on the private bank is of a public nature which varied in the relative influence exerted by the various participants (local government, regulatory authorities and the State) in the appointment of the members of corporate organs and of the officers of the company.

4.4. Company law reform

The recent company law reform seems to have emphasized the tendency of banks to be controlled by small groups of people on the basis of this abnormal and unofficial system of control. It has encouraged the duplication of this system in those industrial and commercial enterprises participated by the banks. The rights of diffuse public shareholding have been drastically reduced and those of others have been practically eliminated. At the same time, the powers of the Managing director have grown, his independence from the Board strengthened (while, in the meantime the powers of Boards have been proportionally weakened), his vulnerability to claims for damages for conflict of interests and criminal liability for false accounting lessened or entirely eliminated.

V

CURRENT THEORIES IN RELATION TO DIRECTOR'S DUTIES

According to traditional theories, it is the proper organisation of internal corporate powers and the introduction of checks and balances which provide the technical means of avoiding abuse in the management of risks. The general meeting should have power to appoint and terminate the Board of Directors and thus be able to effectively monitor management of the company. The Board should protect the interests of the shareholders, even minority shareholders. External auditors assist shareholders by certifying and disseminating corporate data. The market is the ultimate conditioning force: shareholders, who are the risk takers, decide the appointment and termination of management mandates.

Other theories have a different model which is based on a different concept of either the nature or content of the fiduciary duty or intent on substituting the fiduciary duty with something else. These theories view differently the nature of the duties of company directors and of their role as managers of third party interests. One needs to understand to what extent any restructuring of internal powers is still capable of avoiding the natural abuse that concentration of power tends to generate and evaluate whether the market is or should be the dominant determining influence.

5.1. Institutional theory

According to this theory, inasmuch as it is a legally separate person, the interests of the company do not coincide with those of the individual shareholder or of any other individual component of the company. The duty of the company director is to pursue the company's interests even if this means sacrificing the interests of individual shareholders, of workers and so on.

This theory however does not indicate what remedies should be available when the director does not properly perform his duties. In socialist or corporativist systems, it is the State that steps in to protect the interests of stakeholders. Hence in intensely regulated sectors such as the banking industry, the Regulatory authority by using any number of instruments at its disposal can affect the governance of a company and effectively exercise so called moral suasion. Unfortunately internal governance consequently suffers from indeterminacy and in any case the social component tends to blunt the role of market influence.

The institutional theory recalls the US white collar conception according to which white collars can best interpret the interests of the company and strike a balance between the interests of shareholders avid for dividends and the interests of workers who naturally push for higher wages.

5.2. Stakeholder theory

According to this theory, company directors have a fiduciary duty not only towards shareholders, but also towards employees, creditors, consumers and other communities with which the company interacts. This model derives from economic theory and fails to explain how the fiduciary duty of directors relates to the detailed duties which law, regulations and contract impose on them in relation to environment, creditor, employee and consumer issues. Moreover, it does not indicate which remedies should be available with respect to breach of such extended fiduciary duty. There is a danger that this view of things, may turn out to be a justification for acting disloyally towards shareholders, for a dilution of the fiduciary duty owed and a watering down of accountability to the market.

5.3. Beyond the fiduciary duty

The neoclassical approach, which emphasizes the need to deregulate the markets, tends to consider outmoded the concept of fiduciary duty. Recent American scholars have identified a tendency to adopt this view in some state and federal legislation. The sanction of contract is considered sufficient to protect against abuse in preference to fiduciary duties which tend to limit the managing director’s freedom of action and thus the efficiency of the economic system. The market is thought to be the final judge of performance and, in the absence of legal protections, it is the shareholders who will be pushed to carefully evaluate risks and performance.

I can see this tendency in recent Italian reforms. Reference to the mandate of directors is eschewed when delineating their role and some authors contend that the fiduciary duty has been replaced by a judgment as to adequacy of performance: indeed, but what exactly does this mean?

All these theories have different views of the function of the joint stock company. According to the contractual theory of the company, the shareholders are the principal source of funding for a company (risk capital) and it is therefore right that they decide the appointment of the Board of directors, and its termination, through the General Meeting. In order to facilitate funding of companies on the medium long term market, it is necessary to develop the securities market and the stock exchange market, introduce legislation which protects minority shareholders and diffuse public shareholdings, as well as debenture holders. The private limited company also depends on the market, since the decision to invest in the company on the part of its limited shareholder base is determined by market conditions and the availability of alternatives. The institutional theory contends that the company (and its directors) are not necessarily dependent on the market and public savings; rather, the natural point of reference for the company is the banking system, credit institutions sensitive to governmental inputs, indeed to the State itself. Bankruptcy laws are also modified in this sort of system, since insolvency can be negotiated with the banks and State shareholders and, where there is the danger that a corporate bankruptcy can lead to systemic risk, recourse to extraordinary public financing is available[2]. In this manner the company rather than being primarily a means of financing business initiatives becomes an instrument of organisation, almost a foundation. The repercussions on the constitutional set up of a nation are evident: it becomes increasingly difficult to maintain the effective separation of economic and political power.

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CONCLUDING REMARKS

Different theories of the nature and functions of the company reflect different realities. The contractual theory of the company describes the Italian situation in relation to private family firms: in these cases, shareholders are physical persons that invest savings according to private capitalistic criteria. On the other hand, large companies in Italy do not seek family savings, nor become joint stock companies in order to fund themselves from the general public. These public savings are in fact managed through the banking system which takes in deposits and manages investment funds. Consequently, the banking system has a major influence on the appointment and termination of the Board of directors. The banking system itself hardly feels the influence of the market, as such. The institutional theory best describes this situation.

This sort of situation generates a real cost to the Italian system which is positioned within a wider European system. In order for it to maintain growth, it must change. Corporate reform, from the institutional regime to the contractual one can only be accomplished after reform of the financial system and reform affecting the relationship between the financial system and the largest Italian corporations.

Each of the aforementioned systems is strictly conditioned by a number of characteristics which are peculiar in different legislations.

[2] The need to deal with corporate crises outside the market encourages in these systems the development of extraordinary administration procedures in substitution for ordinary insolvency regime.

The transplant therefore of solutions which fit in one system is not necessarily the best solution for another. Nor can it be said that a system is better than another just on the basis of its hypothetical alleged efficiency.

However, one element which we may find common to all systems is the procedural and transparency profile. Indeed, procedure and transparency are essential for manifesting the division of powers and the specific attribution of roles and competences. No matter what theory of fiduciary duty is adopted, the various possible remedies that may be available can only be effective if the decision making process has followed a specific procedure allowing the various interests at stake to be disclosed and consequently evaluated: this will then allow the beneficiaries of the fiduciary duty to ascertain who, and on what basis, assumed a business decision and therefore who can be held accountable for it.