***Organisation for Economic Co-operation and Development***
***In co-operation with the World Bank Group***

***The Third Meeting of the***
***Latin American Corporate Governance Roundtable***

*8-10 April, 2002*

*Bolsa Mexicana de Valores, Mexico City, Mexico*

# DIRECTORS' DUTIES AND DIRECTORS' LIABILITIES
## (A framework for the law reform in Latin America)

by


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# I. INTRODUCTION.

## § 1. Corporate Governance, Fraud and Negligence. A Working Hypothesis.

The aim of this presentation is to understand the relationship at work between the rules of law and market forces and, from there, to establish the bases of a legal policy concerning director liability capable of providing operators with guidelines for designing their governance structures, lawyers with criteria for interpreting the legislation in force and legislators with elements of reflection for a legislative reform which, *ceteris paribus*, will allow a firm's value to be maximized and consequently facilitate the development of capital markets. It is therefore a matter of establishing the point of equilibrium in the director liability system that will allow this efficiency objective to be achieved. I am aware of the fact that this point of equilibrium is not an universal one, that it depends on the conditions of individual markets, on the institutions operating in individual environments, on the circumstances involved in individual companies and even on the preferences of the parties thereto. I also realize that the calculations needed to carry out this task are not easy to perform. In most cases it would even be impossible to carry them out (how could we determine, for instance, the aggregated cost for directors of Spanish corporations of the suppression of the exemption for ordinary negligence brought into operation by the 1989 reform?). This circumstance, however, should not dissuade us from the task (v. *Williamson*, 1989, p. 32). A quantitative calculation can be replaced by a qualitative weighting or estimation of the phenomenon concerned, which furthermore constitutes a lawyer's most typical job.

In our opinion, the fundamental bases for this qualitative estimation are to be found in an analytical separation of the *technological aspect* (managerial capacity to produce the highest returns) from the *deonthological aspect* (management's willingness to distribute gains in the most equitable manner) and in the corresponding distinction within the so-called fiduciary duties between the *duty of care* and the *duty of loyalty*[1]. The duty of care - the duty of diligence of the "orderly businessman" - requires directors to invest a specific amount of time and effort and to develop a specific level of expertise devoted to management or supervision of the company with a view to

[1]A terminology precision: it is fairly frequently said that the fiduciary duties doctrine - the distinction between the duty of diligence and the duty of loyalty - has Anglo-Saxon roots, perhaps with the unconfessed desire to encourage doubt on the possibility that this plant is capable of growing on continental soil. We would react strongly to this because the only truth in it is the fact that the "fiduciary duties" nomenclature is Anglo-Saxon; this is not the case with the underlying substance, because in the continental tradition a distinction has always been made between the two types of duty, albeit with diverse legal justifications (v. *Hopt* 1992, p. 115 et seq.).

maximizing value production. The duty of loyalty - the duty to act as a "loyal representative" - calls for directors to put shareholder interests before their own so that as a result the redistribution of the value created is minimized[2]. This distinction subsequently gives rise to another one, that sets *acts of mismanagement* (owing to a lack of expertise, attention or dedication) against *acts of misappropriation* (or acts of diverting value from the corporate sphere to the individual director's sphere or that of his/her next of kin). And to another one, that sets negligence – in the strict sense - against willful misconduct *(dolus)*. In this respect it must be borne in mind that breach of duty of loyalty normally involves willful misconduct and, vice-versa, that willful misconduct is usually an expression of disloyal or unfaithful behavior[3]. And this way we come to the *summa divisio* of the breaches a director may incur: *fraud and negligence*[4].

Now, starting off from these elementary distinctions, which are extremely important from the point of view of corporate governance but frequently overlooked in the more conventional legal treatment of director liability in the European and Latin American tradition, we arrive at the hypothesis we propose to develop in the present study. The hypothesis can be stated in the following terms: *the liability system must be structured in such a way that it is as stringent with fraud (willful misconduct) as it is lenient with negligence (negligent conduct).* In short, we advocate ways of arbitrating an abstention policy where negligence is concerned and an intervention policy where disloyalty is involved.

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[2]The expressions in inverted commas are taken from art. 127 of the Spanish Company Act (hereinafter "SCA"). Notwithstanding, we find equal definitions in the majority of Latin American legislations - this is the case, for instance, with art. 171 of the Peruvian General Company Act - or similar definitions for duties of diligence and of loyalty. Thus, for example, art. 59 of the Argentinean Commercial Company Act (hereinafter "CCA"), provides that: "*Directors and company representatives should act with the loyalty and diligence of a good businessman*". Similar terms are used in arts. 153 and 155 of the Brazilian Company Act (hereinafter "CA") (*"o administrador da companhia deve empregar, no exerício de suas funçoes, o cuidado e diligencia que todo homen ativo e probo costuma empregar na administraçao dos seus própios negócios"; O administrador deve servir con lealdade a companhia e manter reserva sobre os seus negócios"*). Still more abstract is the Mexican legislation. I am referring to art. 157 of the General Corporations Act (hereinafter "GCA"), pursuant to which: *"Directors shall be subject to the liability inherent to their position and that derived from the obligations imposed by the Law and the Statutes".*

[3]In the words of *Halperin & Otaegui*, 1998, p. 546, "lack of loyalty stems from simple acknowledgement of the abusive or fraudulent nature of the deed being judged, at the time this emerges".

[4]The central nature of this distinction, for the purposes of the interest herein, is adroitly underlined by *Scott* (1983, p. 927-928; and 1986, p. 299-300 and 307-308). For a different point of view, v. *Fischel & Bradley* (1986), p. 290-291. There is undoubtedly a continuum flowing between the two extremes that is not always easy to situate (v. *Whincop* 2001, p. 5). Notwithstanding, we shall dispense with this for the purpose of defining the general argument, without prejudice to making the appropriate qualifications when the time comes.

We hasten to note that the point of view underlying the hypothesis we have just formulated goes against the tendencies that have traditionally presided over the development of the European doctrine, at least that part affiliated to Latin doctrine and, most certainly, to Spanish and Latin American doctrine. The director liability map drawn by our tradition - albeit not without a certain degree of exaggeration - to a large extent is opposed to the layout traced in our hypothesis. It is characterized by the enormous stringency with which breaches of duty of care are contemplated and the scant attention paid to breaches of duty of loyalty. Deep down, what has occurred is that the liability doctrine has been developed over duties of diligence and has subsequently spread in mechanical fashion to duties of loyalty. A good illustration of this is the scant development given the duty of loyalty in continental company Acts and in actual case law experience[5]. Spain provides a classic example in the latest reform from which the 1989 Company Act arose. On this occasion all efforts went towards increasing the liability system for breach of duty of diligence (suppression of the exemption for ordinary negligence, establishment of joint and several liability, inversion of the burden of proof, etc.)[6]. On the other hand, neither the legislator nor the doctrine accompanying it on the adventure were concerned in the slightest over hardening the liability system for breaches of duty of loyalty, nor from the point of view of defining assumptions, nor from the point of view of facilitating enforcement nor, finally, from the point of increasing sanctions. In this respect things continue more or less as provided in the 1951 Act. The preventive effectiveness of the legislation has hardly been reinforced.

Things only appear to have begun to change in recent years as a result of the publication of the *Olivencia Report* that drew attention to this important omission. It seems to me that the efforts of the international institutions that have organized this Conference (OECD, World Bank and IMF), are aimed in the same direction, at improving corporate governance by protecting the rights of

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[5]Even in Germany, undoubtedly the most advanced country on the continent, things have not gone very far. The most detailed and recent monographic study on the matter warns us that the development and elaboration of the "liability principle for disloyal management" is still at the teething stage: "*steht erst am Anfang"* (*Abeltshauser* 1998, p. 271)

[6]The full census of the legislative modifications introduced by the 1989 SCA in respect of the 1951 SCA includes: activation of the liability for ordinary negligence or for simple offenses of negligence; joint and several liability of all members of the administration body; reduction to 5% of the share capital minority shareholders must have in order to bring director liability action or to make their opposition effective to an agreement to settle or waive the exercise of director liability action; extension of the cases where minority shareholders are entitled to bring director liability action (lack of call of a General Shareholders' Meeting); limitation of the waiting period to one month for minority shareholders to bring director liability action in default of the company; capacity of creditors to bring the action when corporate assets are not sufficient to meet all the damages claimed; (*Martínez Machuca*, 1997, p. 1157).

minority stockholders (OCDE 1999; *Nestor*, 2000 and 2001; *Iskander et al.,* 1999; etc.). Furthermore, the consistency of this policy appears to be backed by the most recent and most widely-accepted academic research in *law and finance*, which has demonstrated by highly ambitious and most intelligently designed empirical studies the existence of a powerful correlation between the development of capital markets - in terms of liquidity, depth and size - and the protection of the rights of minority shareholders. We essentially owe the pioneering or path-breaking studies in this field to two Mexican professors, Rafael La Porta and Florencio López de Silanes (*La Porta et al.* 1997, 1998, 2000). The innovation of this movement lies in its having focused on Law and highlighted the importance of the *legal dimension* for understanding the way capital markets develop. It is not therefore surprising that it has begun to flourish precisely with modifications in corporate law and securities law aimed at strengthening shareholders' rights. The most recent examples in Latin America consist of the reforms of last year in Brazil (Act.303/2001), Argentina (Decreto 677/2001) and Chile (LMV and Act 19.705/2000). Even with all this I believe we still have a long way to go.

**§ 2. System Presentation.**

The rest of the presentation is divided into three major sections. The first is designed to demonstrate the economic rationale of our hypothesis on flexibilizing liability for negligence and hardening liability for fraud. In the final instance what this involves is demonstrating that this double strategy of leniency and stringency is the most appropriate for cutting down transaction costs and therefore for maximizing the firm's value and the benefit of its shareholders (v. *infra* II).

The second section is devoted to the treatment given to liability for fraud. Our proposal for severity or stringency stands on the threefold plane of the characterization of disloyal conduct, facilitation of litigation and increase of sanctions. Indeed, we suggest that the most significant fiduciary duties should be specified in appropriate detail, as this would facilitate the control task of judges and, at the appropriate time, encourage greater perceptibility of contravening conduct; extending the system of directors' fiduciary duties to the live powers behind them, in particular to the controlling shareholders; extending the capacity to bring director liability action; increase the transparency regime of transactions involving conflict of interest and inverting the burden of proof; and increasing sanctions by restituting enrichment and punitive damages (v. i*nfra* III).

The last section covers liability for negligence. Our aim here is to explore ways that would allow the excessive stringency of the legal system to be attenuated, both in the field of interpreting constituted legislation (which we believe is sufficiently loose-fitting to be flexible) and in the field of statutory design. The central topics for discussion are the business judgement rule, the quantitative limitation of damages, the liberalization of civil liability insurance and the need to open up the treatment of this matter to freedom of contract (v. *infra* IV).

## II. THE ECONOMIC ANATOMY OF DIRECTORS' LIABILITY.

### § 3. Firm's Value and Director Liability.

In order to clarify the economic rationale behind our hypothesis it is worth explaining the relations at work between the firm's value and its directors' liability in their simplest terms. To this end the following facts must be borne in mind: the firm's value depends on its capacity to generate profits; the capacity to generate profits depends on its capacity to cut costs; and finally, the capacity to cut costs depends on technology - physical technology (that cuts production costs) but also contractual technology (that cuts transaction costs). It is therefore easy to understand that cutting transaction costs, that is, the costs of defining, monitoring and enforcing the contract system into which the firm is broken down, determines the increase in the firm's value[7].

And this brings up the question of the directors' liability system, which should be taken as one more item of a firm's contractual or transactional technology. Its function is to lower the transaction costs derived from keeping the ownership separate from the management characteristic of corporations and explainable as a function of the divergence of interests existing between the fund providers (shareholders) and the fund managers (directors). The director liability system cuts these transaction costs - agency costs - by aligning director incentives with shareholder interests. The threat of having to repair or indemnify the damages caused by misconduct - failure to comply contractually - actually works as a deterrent so that directors manage a firm in accordance with its owners' interests.

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[7]To be more precise, we should specify that it is interdependent variables that are involved here: a firm's value is maximised by minimising the sum of the transaction and the production costs, as certain technologies can increase the former and cut down the latter or vice-versa (v. *Matthews*, 1986, p. 903 et seq.).

Logically, the more stringent the liability, the greater the preventive effect will be, but it does not necessarily follow from this that the greater this stringency, the higher will be the firm's value and, consequently, the shareholders' profit. The mistake sometimes made by our lawyers and regulators stems precisely from the assumption that the correlation between stringency of liability and firm's value is a linear or monotone in the sense that any rise in the former will go hand in hand with a rise in the latter. And yet in reality the fact is that this linear relationship does not always exist. What frequently happens is that when a particular threshold is exceeded, the increase in the stringency of the liability can produce the opposite effect to the one hoped for - cutting down the firm's value. "Corner solutions" do not always provide optimum answers (*Butler & Ribstein*, 1995, p. 6). The reason for this will be obvious if we take into account the fact that setting up any governance mechanism (and liability is one of many) is not cost free and, as a general rule, involves an ongoing marginal cost (for the directors) and a diminishing marginal benefit (for the shareholders).

With this as it stands and as we are up against a contractual relationship governed by the logic of mutual advantage, it is easy to see that the optimum degree of liability stringency lies midway along the full range of possibilities - exemption of liability and objective liability[8]; precisely at the point where the cost for directors to commit themselves to a certain degree of liability is equal to the benefit for shareholders of having the directors committed to this degree of liability. This is the point of equilibrium at which, all other things being equal, the firm's value is maximised[9].

The reasons why we believe that the stringency/leniency strategy we have formulated in our hypothesis lies within the equilibrium zone are based on a comparative evaluation of fraud and negligence - liability for breach of duty of loyalty and duty of diligence - on three planes: (i) on the plane of incentives for breach; (ii) on the plane of the substitutability of governance mechanisms; and (iii) on the plane of the legal assessment of the directors' conduct.

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[8]For practical purposes objective liability can be equated to liability for ordinary negligence when the burden of proof is inverted, which, according to some authors, is the system provided by the Spanish Company Act currently in force.

[9]Beyond this point - either below or above it - we are in suboptimal scenarios in the Pareto sense, as there are possibilities for contracting liability clauses with advantages for both parties. If we are below this point, it is in the shareholders' interest to increase the stringency and they are in a position to do this because the benefit they obtain is greater than the cost taken on by the directors: they will pay the directors to agree to it on a voluntary basis. And vice-versa: if we are above this point, it is in the directors' interest to lower the stringency of the liability and they will be prepared to pay the shareholders - in the form of accepting lesser remuneration - so that the shareholders agree to the change. Note that we are facing a further application of the Coase Theorem (v. *Demsetz*, 1972, p. 14).

## § 4. Breach Incentives and the Different Conduct Dangers.

The first factor to be taken into account when choosing between a policy of stringency or of leniency at the time of setting up the rules for director liability is the extent of natural alignment existing between management incentives and shareholder interests. The magnitude of this variable depends, as can easily be seen, on the return obtained by directors from failing in their duties. All other things being equal, there will be a greater abundance of the type of breach that produces profit for the defaulters than the breaches that do not produce this. It follows from this that the essential concern of any director liability system must be aimed at breach of loyalty duty, because this is the typical conduct that produces the greatest advantages for its perpetrators. The problem does not arise, however, with negligent conduct, because defaulters of this do not usually derive much benefit from it. The gain tends to be limited to less expenditure in terms of attention and effort but not to obtaining any returns. If this were the aim, we would already be in the field of willful misconduct[10]. To sum up, in order to determine the danger of the different types of conduct it is critical to distinguish between management decisions, where directors and shareholders share the common interest in seeing the business prosper, and self-dealing transactions, where interests are not aligned in any way.

## § 5. Governance Mechanisms and Different Levels of Enforcement Substitutability.

The second factor to take into account at the time of weighing up the stringency to be applied to the liability system is the degree of substitutability of the liability rules as governance mechanisms. In this respect we should point out that a policy of leniency will be more justifiable in cases where the firm is planned to have other (formal or informal) governance mechanisms in place to reduce agency costs and, on the contrary, it will be counterproductive in cases where no effective alternative disciplinary mechanisms exist. In the latter case a stringency policy would be advisable. Having got this far we can now state that a substantial difference is also to be seen between the breach of duty of loyalty and the contravention of duty of care.

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[10]As *Posner* (1998, p. 452) so succinctly puts it: “The danger of mismanagement (negligence) is less serious than the danger that the managers will not deal fairly with the shareholders (disloyalty). Mismanagement is not in the managers’ self-interest; it is in fact very much contrary to their self-interest, as it will lead eventually to the bankruptcy of the firm (and of the managers’ future employment prospects), as a result of the competition of better managed rivals. Although managers thus have a strong incentive to manage the firm well or, if they are unable to manage it well themselves, to sell their offices to those who can, their incentive to deal fairly with shareholders (meaning, maximizing the per-share value of the corporation’s stock) is weaker”.

Corporations - particularly public corporations - possess powerful market disciplinary mechanisms that reduce the need to resort to the legal system to constrain the negligent conduct of their directors. It must be borne in mind in this respect that substitutability exists between legal safeguards (liability rules) and market safeguards (economic incentives), and that therefore the parties concerned will be less inclined to resort to legal safeguards - and to the inevitable costs they involve - when the market affords other cost-free safeguards. And this is precisely what happens in the context of public corporations, owing to the fact that (i) directors are subject to highly substantial reputational effects as they are constantly approaching markets in search of resources (repeated transactions)[11]; (ii) they make specific investments in the firm that they cannot recover if they are dismissed[12]; and (iii) they live under the permanent scrutiny of highly efficient markets from the information point of view (stock market, corporate control market, top executives market) (for further development of the substitutability argument in this context, *Fischel & Bradley*, 1986, p. 264-270; *Easterbrook & Fischel*, 1991, p. 94-97; *Butler & Ribstein*, 1995, p. 7-13 and *Rock & Wachter*, 2001). For private corporations, the incentives for diligent conduct are to be found in the smaller separation existing between ownership and management. The fact that many directors are also company owners provides them with an enormously powerful natural incentive to perform their duties with the correct levels of attention and effort.

Corporations, on the other hand, do not dispose of alternative mechanisms for the liability rules proving equally effective for disciplining disloyal conduct, and there are three basic reasons for this. In the first place, because the very nature of such conduct makes it less discernible. It usually involves self-interest transactions where, precisely as a result of the excessive advantages directors draw from them, they tend to be disguised -both objectively (through complex structures) and subjectively (lodged by third parties or other entities) - to steer them clear of public scrutiny. Negligent conduct, precisely because it is generally not conscious or voluntary, is far more discernible (v. *Scott*, 1986, p. 301-302). In the second place, because breaches of duties of loyalty tend to multiply at the end of directors' relationships with a company, and at this time market discipline is highly debilitated. The only effective remedy against conduct of this nature - the so-

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[11]Even in the realm of small enterprises this forms a basic factor, as revealed by the empirical studies recently carried out in Germany (on which *Schanze*, 2000, p. 14 et seq. reports).

[12]Bear in mind that if the director liability action prospers, the directors are automatically dismissed (v. art. 134.2 II SCA).

called "*pelotazos*" of the Spanish financial jargon or *one-shot fraud* - is accountability to the courts[13]. And in third place, because in the duty of loyalty field ownership by the directors of a substantial tranche of the firm's value does not help in any way to prevent fraud. Instead it encourages it rather, because if directors are insured against the risk of reversal because they own a substantial block of shares, they may even feel protected enough to try to extract excessive personal advantages from the company, which ought to be shared with the minority shareholders. Experience has in fact taught us that in markets with high rater of ownership concentration there is a higher risk of minority shareholders being expropriated[14].

### § 6. Uncertainty, Risk of Error and Overcompliance.

The third factor to bear in mind for setting an optimum level of stringency in directors' liability is the extent of legal uncertainty in which such decisions are taken. Without a shadow of doubt this is the decisive factor. As it is easy to appreciate, if the uncertainty involved is only slight, there will be justification for finding ways to impose a stringent or harsh liability policy. On the other hand, if the uncertainty is considerable, it would be advisable to apply a lenient policy. As this line of argument is somewhat complex let us take it part by part.

#### 6.1. The Parameters of Uncertainty of the Negligence Judgement.

Uncertainty occurs when directors cannot anticipate the legal consequences of their decisions with any certainty[15]. There are several grounds for this scenario: (i) the ambiguous or generic nature of the legal mandate - it is difficult to determine in advance whether a judge will consider correct or otherwise the way a particular operation has been carried out (errors on the part of the judge in determining the degree of correct conduct involved); (ii) difficulties of providing burden of proof: even knowing that a decision is diligent, it is possible that a director may fear not being able to

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[13]As Harold Demsetz rightly said, "The takeover market, the market for managerial services, and the market in which a firm's shares are priced, for example, judge managers and bind them to the shareholders' interests. These markets however are more likely to be effective for duty of care problems than for duty of loyalty problems because their efficacy depends on management's desire to continue to serve as professional officers of business firms. Duty of loyalty problems are more likely to be associated with a willingness to disengage from professional management. The risks taken in the commission of fraud, theft, or self-dealing would seem to require a psychological disposition to be willing to "chuck it all" for a single shot at a large take. Thus, investors need the derivative suit to supplement market protections against breaches of loyalty" (*Demsetz*, 1986, p. 355).

[14]We shall deal with this aspect in some detail at the end of this study (v. *infra* §).

[15]On this topic it is inexcusable not to refer to *Calfee & Craswell* (1984, p. 89 et seq.).

convince a judge of this fact (errors on the part of the judge in verifying a specific level of correct conduct); and (iii) the cognitive deficiencies of the agent proper: the actual director may fear not being sufficiently aware of the legal correctness of all the actions carried out (incapacity on the part of the director to permanently monitor his or her levels of care) or of making a mistake at the time of assessing the legality of conduct (error on the part of the director in determining the level of care involved).

The level of uncertainty involved determines the risk of error to which agents will be subjected (in other words, the risk of incurring liability for action which they do not deem incorrect) and this risk, in turn, gives rise to the problem of overcompliance which can prove to be very substantial in economic terms. Those who anticipate the possibility of a judge's error will make every effort to extreme the precautions they take over and above those required by the duty of diligence. A policy of leniency will therefore be advisable when the risk of error is high and the costs of overcompliance are considerable[16]. And vice-versa, a policy of stringency will be advisable when the risk of error and overcompliance costs is only small.

### 6.2. The Error Risks in Negligence and Disloyalty.

From the point of view of error risk, there are considerable differences between liability for negligence and liability for disloyalty. In principle, it is intuitively obvious that cases of willful misconduct scarcely involve any risk of error for directors because: (i) breach of duty of loyalty constitutes the type of contravention where directors are not very likely to make an error of judgement - since what is involved here are operations that disqualify themselves precisely on the grounds of drawing excessive personal advantage, everyone knows where the boundaries lie - and (ii) there is also very little possibility of a judge making a mistake because, unlike what happens with a judgement on negligence that involves a complex technical and economic assessment, the

[16]"If defendants have an incentive to overcomply, setting the nominal standard at the optimal level of care will lead defendants to take more than optimal care, which by definition is undesirable. Society would be better off if juries were told to try for a standard somewhere below the cost-effective level of care, so that the defendant who overcomplied relative to this standard would end up exercising the optimal amount of care" (*Calfee & Craswell*, 1984, p. 97, v. also *Calfee & Craswell* 1986, p. 279 et seq.).

judgement on loyalty is a moral issue and judges are well equipped for this (v. *Demsetz*, 1986, p. 356; *Gower*, 1992, p. 586)[17].

On the other hand, negligent conduct poses serious problems of error. We are essentially referring to the type adopted in the field of business management. The risk stems from the scant training and experience judges have in this field and from the inexistence of a consolidated *lex artis*. The result is that it is highly likely that poor financial results will tend to be equated with breaches of diligence[18]. The problems Courts face are also aggravated by what is known as "*selection bias*" in statistical terms. As the majority of cases follow on poor financial results, Courts tend to assume they are the outcome of breaches of duty of care (v. *Fischel & Bradley*, 1986, p. 266). The increase in error risk gives rise to company costs on two scores: on the one hand it bumps up the cost of managerial capital and, on the other, it inflates the cost of risk management.

It is obvious that if directors are subjected to a risk beyond their own control, they will put up their remuneration demands. At the end of the day the company picks up the bill. But the cost does not only involve increased remuneration; in many circumstances the cost will involve not being able to recruit talented directors precisely as a result of the difficulties of structuring an appropriate remuneration scheme. Economic literature has stressed the serious problems involved over compensating directors for the liability risks associated with their work as a result of the enormous difficulty of monitoring and assessing their performance (*Diamond & Verrecchia*, 1982, p. 275 et seq.).

Under the prism of risk management the problem is even greater owing to the different attitudes existing over the risks among shareholders and directors. Generally speaking, directors are always more averse to risk than shareholders are, given that they have specific human capital invested in the company (that is, a capital that can not be employed alternatively elsewhere), and

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[17]I cite Gower's graphic example: *"The judges have faced a further difficulty. Whereas their training and experience may make them well equipped to adjudicate on questions of loyalty and good faith, they move with less assurance among complicated problems of business administration. Hence, they display an understandable reluctance to interfere with the directors' business judgement - a reluctance of which many examples will be found throughout the whole area of company law. Perhaps, too, they are conscious of the possible unfairness of attempting to substitute their hindsight for the directors' foresight, and are therefore unwilling to condemn directors even though events have proved them wrong".*

[18]For a more detailed analysis v. *Chapman* (1996, p. 1679 et seq.). The treatment is of interest because it highlights the damage caused by overcompliance not only from the economic point of view (efficiency), but also from the moral angle (commutative justice).

human capital is not diversifiable. This does not happen - or does so to a lesser extent - with shareholders and far less so with shareholders of public companies, who can distribute free of charge the costs of the risks involved in their investment by diversifying their portfolios until they become neutralised to the risk. In a situation like this it is highly inefficient to offload directors with a risk that shareholders can handle better.

### 6.3. The Costs of Overcompliance.

From the point of view of overcompliance costs, the differences between negligence and disloyalty are also substantial. The problem of overcompliance lies, as we stated earlier, in preventing the legitimate conduct it gives rise to and in the alternative value such conduct could acquire for the company. Now, on this plane we would once again establish that a very stringent disloyalty liability system scarcely causes any pitfalls; the worst that can happen are retractions on a few operations between insiders that are beneficial to the company, the accumulative effect of which can never be very significant in comparison to the operating statement. The serious problem arising with liability of negligence is that it is capable of seriously hampering company progress on two scores that are closely interlinked: "conservatism" in management and "paper walls".

Conservatism is the outcome of the directors' risk aversion referred to above. This determines the fact that business strategies are planned at a lower level of risk than would be desirable to shareholders, who are more impartial to the risk. The corporate contractual theory has revealed the serious problem this particular agency cost represents because it leads to the rejection of investment projects that are highly profitable but involve high variance. Now, the difficulty with a stringent discipline over directors' liability is that, instead of mitigating this problem, it makes it substantially worse. Directors will be even less disposed to undertake risky business deals than they would be under a more lenient liability system. And not only this, they will be less favorably inclined towards innovating organizational and managing structures outside the established norms[19].

Error risk and risk aversion also give rise to a highly inefficient form of precaution. I am referring to what has graphically been termed "paper walls". The incentive created by stringent liability rules leads in effect to defence barriers being put up for every decision: decisions are not

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[19]A document drawn up by the *Australian Institute of Company Directors* reveals that the effect of raising director liability is that directors make their decisions based more on the possible ramifications there could be for their personal risk than on company interest (v. *Cohen* 2001, p. 353).

taken unless they are preceded by exhaustive expert reports and opinions (auditors' certificates on the accuracy of financial statements; investment banks opinions on the valuation of assets and operations; engineers reports on production costs; legal opinions of all kinds, etc.). Needless to say this conduct is inefficient in many cases because it gives rise to an unproductive squandering of company resources - management time and company cash. And less obvious than the scant productivity of these investments is the danger of making the agency costs associated with conservatism even worse because all the experts, in their turn, do not want to be accountable for the operations, and this gives rise to the fact that their opinions tend to be conservative (v. *Bjerre*, 1988, p. 802)[20].

## III. LIABILITY FOR DISLOYALTY. BASES FOR A HIGH DETERRENCE POLICY.

### § 7. Statement of the Issue.

Having examined the economic structure of the problem of director liability, we now need to turn back to the question of legal experience. It is well known that in the continental legal systems, and by derivation - owing to a large extent to the Spanish influence - in Latin American legal systems, corporate law has been absent and even tolerant towards self-dealing transactions and other doubtful practices from the point of view of duty of loyalty. It has barely paid any attention to them and when it has done so, this has been with a large dose of ingenuousness. Deep down, the root of the problem lies in having designed director liability rules in a unitary fashion and taking the problem of negligence as the representative example[21].

This method of procedure has led to two gross errors: an error of defect in the treatment of disloyalty and an error of excess in the treatment of negligence. The error of excess must be corrected - as we shall be seeing later on (v. *infra* IV) - by a policy of leniency. The error of defect must be combated by a policy of stringency, - to coin a famous slogan, I would even say by a *"zero tolerance"* policy. There are three basic reasons supporting this policy, as we have contended in the preceding section: (i) the existence of highly intense incentives for appropriation of private benefits,

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[20]Conservatism extends its effect at many other levels, for instance, the levels relative to the organizational and monitoring norms in force in companies (the German experience reported in the studies by *Schanze*, 2000, p. 11 and *Spindler*, 1999, p. 330 et seq. illustrate this aspect).

[21]Only recently has any attention begun to paid to the duty of loyalty. We are alluding to the Chilean, Brazilian, Argentinean and Mexican reforms of 2001.

which determine a high likelihood of disloyal conduct; (ii) insufficient disciplinary or enforcement mechanisms provided by market forces to cut down self-dealing practices and, as a result, the particular need for legal remedies; (iii) scant uncertainty over disloyalty judgements, meaning that the costs associated with overdeterrence or overcompliance are scant. To these observations that are easy to understand from the point of view of common sense or intuition, we must now add the formidable body of empirical evidence recently accumulated on the enormous volume that expropriation acquires when the legal system lacks efficient remedies for combating breaches of duty of loyalty[22].

The question that immediately springs to mind and particularly concerns me as a lawyer consists of determining how a policy of that nature in Latin American legal systems can be articulated, a policy that can naturally not be limited to transplanting the good standards and practices arising in other institutional contexts and most particularly in the Anglo-Saxon environment, but rather a policy that must make every effort to adapt itself to the institutional framework to which it is destined. In the last resort it is a matter of defining a policy in line with the legal tradition that is capable of increasing the deterrent effectiveness of liability for breach of duty of loyalty. This definitely does not only depend on legislators. L*aw in books* does not immediately translate into *law in action;* the effectiveness of regulations aimed at reducing the risk of expropriation calls for other important elements (honest and competent judges [sophisticated enough to understand complex self-dealing transactions]) and reputational intermediaries; etc. (for a full inventory v. *Black 2000* p. 806-811[23]). None of this can be achieved overnight. However, in my opinion a great deal can still be achieved by *law in books* that is precisely designed on the basis of the defects of the enforcement apparatus and focused on creating in the long run an institutional

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[22](v. *Johnson et al.* 1999; *Bae* et al. 2000; *Bertrand et al. 2000*; etc.). Indicatory of this, for example, is the value of control blocks (*Nenova*, 2001; Zingales 1995; v. *Atanasov*, 2001; etc.). Furthermore, the evidence available indicates that the weakness of the legal system accentuates the problem of market volatility, a chronic malady affecting emerging economies. It has been proved, in fact, that when the economic situation deteriorates, the expropriation process intensifies, and this in turn determines an even larger fall in asset prices (fundamental to this issue is the study by *Johnson et al.* 2000, p. 141 et seq.; for the experience over related lending in Mexico, *La Porta et. al.* 2002). From the time of the ground breaking studies of *La Porta* and *Lopez de Silanes* a line of research has gradually been perfected which exposes the fact that the essential problem over the development of capital markets precisely consists of the legal system developing rules and principles that have the effect of reducing the efficiency of expropriating technology or diversion in all its forms, and particularly what has been termed *tunneling* (*Johnson et al.*, 2000a).

[23]Unfortunately this is not the most usual procedure in our systems in which the legal apparatus is frequently underfinanced and unmotivated and is also unfamiliar with business practices. There is also a need therefore for structural reforms that are capable of mitigating these deficits.

framework that encourages the development of appropriate mechanisms. Legislation that genuinely has teeth in it - that increases the riskiness attached to expropriation - constitutes a fundamental incentive for this because, right from the start, it will call for the intervention of appropriate agents - lawyers, auditors, investment banks, etc.- for decision making purposes and these, let us not forget, are the major gatekeepers of the legal system[24].

In order to articulate this stringency policy, we must analyze Latin American legal experience (which I shall do from the angle of a Spanish lawyer and to a large extent looking at the problems occurring in my own country) and determine the reasons responsible for fraud persecution being so ineffective. Only if we know the roots of the problem can we apply a remedy. In my opinion, there are three fundamental causes for the triviality or inoperativeness of the duty of loyalty in our legal systems: (i) the inadequate characterization of disloyal conduct; (ii) the insufficient litigation in the matter of duty of loyalty; and (iii) the insufficient volume of sanctions established. These three insufficiencies have jointly determined the extremely low deterrence level of expropriation practices. And I should add that this non-deterrent balance could have broken down on any of the three fronts. In fact, if the volume of sanctions were much greater, the insufficient litigation or the inadequate characterization of disloyal conduct would be less important as the agents involved could be exposed to an extremely high risk of loss and, naturally, this would boost contention. It could equally be said that the inadequate characterization or insufficient volume of sanctions would prove to be less important or damaging if a great deal of litigation had been built up. In this respect, it must not be forgotten that if judges had had the opportunity to pass repeated judgements on this type of practice, they would undoubtedly have gone building up a solid network of legislation that, as with the Anglo-Saxon environment, would have made legislator intervention unnecessary in other aspects[25]. In any event, I believe it is wise to intervene in each of the three dimensions. From the point of view of legislative techniques the task appears to be a relatively easy one. The problem

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[24]In order to study these enforcement mechanisms operating *ex ante* we would refer you to the discerning study of *Kraakman* 1986, p. 53 et seq. Our application to the Latin institution of the Notary Public (v. *Paz-Ares* 1995, p. 45 et seq.) is also material to be consulted.

[25]What should be remembered in this respect is the experience built up in the continental systems, as also particularly in Spanish Law, with the general "good faith" clause in contract law, pursuant to which an entire valuable stock of legal data has been developed capable of solving the most sophisticated contractual problems. We should also point out that the density of the Law also depends on the amount of doctrine produced, a totally crucial factor for ensuring permanent innovation, improvement and supplementation of the Law. I have studied this issue elsewhere and come to the conclusion that "*the effectiveness of company law depends to a large extent - I would actually say in the most part - on the quality of company law doctrine existing"* (*Paz-Ares* 1997, p. 15).

that will have to be faced, which is definitely not on a small scale, will be the resistance that will undoubtedly be put forward by the organized lobby groups. I am not referring so much to union groups (always concerned that a standard should not prevail which gives priority to the interests of shareholders over a maximization of the firm's value) as to what are usually termed "hard core groups" in Spain, that is, controlling shareholder groups whose capacity for political maneuvers - directly proportional to the weakness of the democratic institutions - should not be underestimated.

## § 8. Inadequate Characterization of the Object and Subject of Disloyal Conduct.

In order to solve the inadequacies detected in the dimension relative to inadequate legal coverage for duty of loyalty, what we need to bear in mind are the planes in which they move and, above all, the reasons behind them. In my view, these can be condensed into three crucial points: (i) the abstract nature of the definition of disloyal conduct; (ii) the artificiality of the authorization procedures; and (iii) the narrow identification of the addressees of the liability system. Let us now examine these three aspects one by one.

### 8.1. Specification of the Duties of Loyalty.

Company Acts in the majority of Latin American countries have traditionally been restricted to setting up a highly generic or abstract type of duty of loyalty. A typical example of this is art. 171 of the Peruvian General Company Act (inspired by art. 127 of the Spanish SCA): all it provides is that directors must act as *loyal representatives*[26]. This legislative laconicism also reflects the general tone of continental European Law. It is true that the legal coverage provided by this general loyalty clause - and also the even more generic coverage provided by the general good faith clause in contract Law - could have been sufficient for the doctrine and case law to gradually build up over the years a rich compound of clear rules and guidelines on the subject. Experience has shown us, however, that this product has scarcely been achieved and, to a large extent, this is also a consequence of the scant opportunities judges have had to pass rulings on these issues and therefore to acquire sophisticated training and expertise on them owing to the lack of litigation existing. The lack of a stock of cases has also meant that on the few occasions when the odd case did reach the Courts, judges were terrified at the prospect of or felt a *horror vacui* over subsuming or lumping

[26]The Company Acts in other countries (v., for instance, art. 59 of the Argentinean CCA) are couched in similar or even more imprecise terms (v., for example, art. 157 of the Mexican GCA).

transactions under such a generic regulation when they were tied up under an apparently impeccable structure and that, faced with the difficulty and isolation of their task, fell back on formalisms to dismiss the action and close the matter without any danger of incurring liability. The end result is that only the most scandalous conduct is repressed, cases where it is virtually proved that directors are caught "red-handed" (in other words, cases that fall directly under or in the vicinity of criminal law). The less reprehensible cases benefit from considerable impunity.

Needless to say the Driving Code could be condensed into a general duty to drive carefully, in the same way that corporate Law has been concentrated into a generic duty to behave in a loyal fashion. But it is obvious that the Driving Code drastically reduces the costs of managing the system by providing unambiguous specifications, even at the risk of their being over- or under-inclusive. As a result of all this, the first step to be taken to strengthen the effectiveness of the duty of loyalty consists of detailing - at least on an intermediate level - the chief obligations derived from the general principle. There is no doubt that this would considerably increase the deterrent effect. As it is, laying down specific rules of conduct: (i) increases the observability and verifiability of the different classes of misconduct and facilitates the job of all the enforcers, judges in particular; (ii) provides standards to guide the conduct of directors; (iii) supplies coverage for operators to be able to withstand improper pressures; and (iv) helps towards creating an appropriate corporate culture which, in the final instance, is the crucial aspect.

This specification work should be developed following up the groups of cases built up by the oldest standing legal experiences in these conflicts and the American Law in particular (the restatement of the American Law Institute in its famous *Principles of Corporate Governance* can stand as reference here, which to a great extent served to inspire my country when the chapter of the *Olivencia Report* on fiduciary duties was written up[27]). The catalogue should at least draw up the following (relative) bans for which directors are responsible: (i) a ban on carrying out related party transactions with the company or its subsidiaries; (ii) a ban on taking advantage on the position as director for private purposes (this should at least include a ban on the use of corporate assets, a ban on the use of information that is confidential to the company or its subsidiaries, a ban on obtaining benefits from third parties linked to company transactions); (iii) a ban on taking advantage of business opportunities of the company or its subsidiaries; (iv) a ban on entering into competition

[27]For the background to Spanish Law, I refer you to the monographs of *Portellano* 1996 and *LLebot* 1996.

with the company or its subsidiaries; and (v) a ban on intervening and voting on matters where a director has a personal self-interest[28]. To these rules must be added special regulations governing directors' remunerations, designed to ensure the reasonableness of the amount (benchmarking), the transparency of their terms and conditions and a minimal impartiality on the part of the body setting them up. A number of precautions will have to be taken when it comes to defining the cases.

**a)** The first precaution consists of anticipating broad-based assimilation clauses designed to neutralize the structures for the interposing and linking of interests and the corporate engineering that can be devised to avoid these. In this respect, it is clear for instance that not only should directors be equated with the related parties and the companies controlled by the former or the latter but also with the entities in which the former hold executive powers and/or have significant shareholdings or even a seat on the administration body in order to curb the practice of interlocking directorship that is so widespread.

**b)** The second precaution consists of using general clauses with an intermediate scope, making it possible for major groups or constellations of cases to operate. The example of the Driving Code cannot be taken to the extreme. In the end it boils down to a question of leaving an ample margin of tolerance for the enforcers so that they can position the constantly renewed tunneling technology. In all events, the intermediary bans must be structured as purely exemplifying bans while the door must always be left open for the general clause of the original basic duty of loyalty. In any case, it is a matter of combining the need of an open provision that gives margin to the judicial development of Law with the necessity of providing a map that will allow Law applicators to orientate within this complex and changing world[29].

**c)** The final precaution is based on formulating the legislation with the proviso that it is applied in accordance with the technique as developed in the field of German tax law concerning

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[28]Let us not forget that the 2001 reforms have taken a step forward in Argentina, Brazil and Mexico. Notwithstanding, the specification of misconduct is still highly inadequate. In particular, this ruling is valid for regulating related party transactions in Mexico and Brazil (the study by C. *Salomâo Fiho*, "Conflicto de interesses: a oportunidade perdida"*on file with the author* is interesting on this point). The reforms however do contain very valuable elements (I am thinking for instance of art. 44 of the Chilean CA and arts. 8 of Decree 677/2001 and 73 and 77 of the Argentinean Public Offers of Securities Act.

[29]All this requires to minimize the unnecessary complexity for the orientation. An excessive complex and detailed rule increases the observancy costs due to the difficulty its addresses will have to find in it an easy and rapid guideline for their decisions and, additionally, for the facility it offers to find holes to those who seek for impunity (v. *Kaplow* 1995, p. 150 et seq.)

the "economic contemplation" of the actual facts (*Wirtschaftliche Betrachtungswiese*), with a view to encouraging legal activism y removing the obstacles of its red tape and bureaucratic culture.

### 8.2. Mandatoriness of the Duty of Loyalty and Exemption Clauses.

The following item of the stringency or strictness policy we propose to make expropriation technology ineffectual is designed to prevent, or at least mitigate, the frequently form-pertaining or purely evasive nature of the authorization procedures adopted in our practice. And to this effect it would seem we need to base ourselves on a number of principles.

**a)** The first is the principle of the mandatoriness of the system derived from the duty of loyalty. What we need to prevent is the possibility that legal regulation can be repealed or amended in the company by-laws or trivialized in some other manner. The argument that freedom of contract is not damaging in this field, because it allows alternative forms of remuneration to be structured for managers, or that in any case it is up to the owners to draw up the contract whichever way they like because the markets will efficiently discount from the share value the anticipated flows of “private benefits” distracted by insiders, is not convincing in any way[30]. This is not the place to waste time justifying this point of view, however, I would like to make a couple of observations. With regard to the remuneration argument, it is unacceptable as it destroys the procedures of fixing remuneration an leads to leave the contract to the sole decision of one party, which is inconsistent with the idea of contract (v. art. 1256 of the Spanish Civil Code). With regard to the discount argument, I would just like to remind you of the apt opinion of Professor *Robert Clark*:

> "[E]ven if shareholders as a class have a fairly good idea of the amount of secret profits taken by managers in the aggregate, and have come to expect this level of unilateral takings to continue, their expectations hardly justify the takings. After all, shareholders also have *expectations about what their rights are*. As long as this is true, expectations about what will actually happen to them cannot be used as the basis for defining their rights (*Clark* 1986, p. 156)".

[30]This is the point of view relatively extended in the literature of the economic analysis of the Law (v. for example, *Easterbrook & Fischel* 1982, p. 734-735; *Haddock Macey* 1987, p. 1461-1462).

**b)** The above principle of mandatoriness does not need to be incompatible with an *ad hoc* principle of exemptivity, by virtue of which the transactions involving a potential conflict of interest that could arise can be authorized on a case by case basis. It is true that this possibility increases the difficulties over enforcing the duty of loyalty, but the draconian counter solution may prove more costly to the extent that it stops many transactions from getting underway which could be potentially productive for the company. What we must not overlook here is the fact that related contracting can produce many profits in terms of savings in transaction costs (information and monitoring costs). In all events, any regulation of the exemption clauses must be given careful thought if the object is to achieve a law that is relatively easy to manage and yet at the same time relatively hard to elude. There are three basic rules to be taken into account here: (i) a rule of procedure capable of ensuring the independent nature of the body granting the exemption in respect of the director concerned; (ii) a material rule of innocuousness capable of guaranteeing that the transaction is fair and carried out at arms-length; and (iii) a rule of transparency in the terms we shall be discussing later on.

The primary rule is of course the rule of procedure. In this respect we could assume that it is enough if the authorization is granted by the Board or by one of its Committees composed solely of independent or outside directors. Notwithstanding, it is our belief that in countries with little tradition concerning this issue, in emerging markets and, naturally, in markets with a highly concentrated ownership structure - variables that all tend to concur- it is not feasible to place complete trust in the hands of outside or independent directors[31]. Additional precautions need to be set up. Some examples are: (i) the need for the operations to receive prior reports from auditors outside the company or from an independent expert or, at least, by an auditing committee[32]; (ii) the need for the most important transactions - for example representing over 5% of the company's asset value - always to be passed by the General Meeting (v. the proposal by *Black* 2000, p. 23); and (iii) the need in the remaining cases for all the transactions to be subjected to ratification by the General Meeting of Shareholders, with the result that the burden of proof is inverted in the event of such ratification not being forthcoming.

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[31]For an optimal study on this issue from the comparativistic point of view v. *Enriques* 2000, p. 509 et seq.

[32]The innovations introduced by art. 14 *bis* 3 IV of the Mexican Securities Market Act or by art. 73 of the Argentinean Public Offers of Securities Act are worthy of note in this respect.

**c)** Naturally, approval by the General Meeting should exclude the votes related directly or indirectly to the parties affected. What we must avoid are the crass charades companies have all too often presented (the things recalled by *Johnson et al.* (2002, p. 13) concerning the Czechoslovakian experience are extremely enlightening in this respect). But there are more. Bearing in mind the problems of collective action that face free float shareholders of listed companies, it will probably be a wise move to reinforce the quorums for passing such measures (two thirds of the capital present for instance)[33] and to be scrupulously careful about regulating the public requests for proxy votes that are made on these occasions.

### 8.3. Subjective Extension of the Liability.

The last item and undoubtedly the most decisive for implementing a policy of stringency for cases of fraud arises as the outcome of extending the application of the regulations governing the duty of loyalty to all the parties who, even without holding a formal directorship, have a similar role in the company. In this case the extension is more justifiable than the original regulation referring to the directors as the greater opaqueness of the activity carried out by these parties, who frequently operate in the shadow or backstage of the formal decision-making bodies, gives rise to an even less disciplinary effectiveness of the governing instruments the market forces provide (*Scott* 1983, p. 938). The extension ought at least to cover the following parties: (i) members of the supervisory board or similar bodies, syndicates and auditors, etc.; (ii) the individuals representing legal entity directors; (iii) the company's senior officers even though they are not board members; (iv) the de facto directors, that is, persons who in the day to day running of the company perform the standard functions of a director without entitlement or with invalidated or lapsed entitlement; (v) the shadow directors, whom we could define as persons under whose orders the company's directors are accustomed to acting[34]; and above all (vi) the controlling shareholders (even though on most occasions they could be accommodated or subsumed under the "shadow director" figure).

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[33]The reason justifying this regulation should not be seen so much to depend on the fact that more inefficient transactions are rejected under it but in the sense that fewer inefficient proposals will be made. Anticipating the existence of a greater control, directors will tend only to submit to shareholders proposals for grant of permission whose forecast profit is expected to go well beyond their expected cost. If directors do not do this, they run the risk not only of having their proposals rejected, but also of suffering considerable damage. A negative vote always constitutes a reputational penalisation for the directors (for more indications on these aspects v. *Paz-Ares* 1996, p. 152-154).

[34]This definition of shadow director is inspired by that contained in *sects.* 320 (3) and 741 of the British Companies Act on which *Schultheiss* 2000, p. 66 et seq. provides a highly appropriate treatment from the point of view of the continental tradition. In the most recent Spanish case law experience a noticeable effort can be seen on the part of

Extending the disloyalty legislation to cover controlling shareholders undoubtedly forms a critical point as the potential for expropriation this type of shareholder possesses can be very high indeed and the figure is common in the continental capital markets and particularly in the Latin American markets, characterized as they are by an enormous concentration of the ownership structure. The empirical evidence gathered in recent times concerning the volume of expropriations these insiders are really capable of is genuinely revealing. Suffice it here to report on the non linear correlations between the firm's value and the rate of ownership concentration (for instance, in Spain the share value rises in the concentration range up to 30%, drops in the 30-65% range and then rises again in the top portion: v. *Pintado & Torre* 2001, p. 9-10) or the elevated premium at which the controlling blocks are negotiated in emerging markets (often over 30% and sometimes over 50% of the Stock Exchange value, as is the case for instance in Mexico (cfr. *Nenova* 2001)[35]. In order to obtain the appropriate legal certainty, the legislation should lay down a specific definition for the figure. The possibilities are varied. Notwithstanding, in my view it would be wise to formulate this on a broad basis - as is customary in our securities market legislation (v. art. 4 of the Spanish Securities Market Act) - in such a way that it would take in all the parties who directly or indirectly, alone or jointly with third parties, hold the majority of the corporate stock carrying voting rights or who, given the circumstances, are in a position to sway majorities at the company's General Meeting. The definition should be accompanied by an assumption which deems that a person possesses this capacity of influence whenever they hold a fraction equal to or above 25% of the stock carrying voting rights and no other person exists who directly or indirectly, alone or jointly with third parties possesses a larger fraction (v. *ALI* 1994, 1.10). Naturally, the above provisions should apply to groups of companies even though in this case and where appropriate they should be coordinated with the regulations which, in exceptional circumstances and backed by all types of guarantee, allow subsidiaries to be managed in order to maximize group interests in general and specifically the holding's interests in particular.

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judges to incorporate these "shadow director" figures into our legal store of knowledge as also the figure of the "de facto director" both of which lack legal characterization (*Perdices* 2002, p. 345 et seq. provides abundant information on this issue; v. also *Sánchez Alvarez* 1998, p. 117 et seq.).

[35] V. also *Atanasov* 2001; for Europe, v. *Faccio & Lang* 2000; for the Spanish case, v. *Pindado & Torre* 2001; v. for an expansion of the general argument, v. the surveys of *Shleifer & Vishny* 1997, p. 758-761 and *Holderness* 2001, p 4 et seq. Incidentally, allow me to point out that the ground-breaking study in *law & finance* by *La Porta et. al* could be further developed by focusing more attention on this variable - the duties of loyalty of controlling shareholders. There it forms just another of the six ways employed as a yardstick for the quality of the legislation existing in the different countries: v. *La Porta et al*., 1998, p. 120).

Finally, we need to add that extending the duty of loyalty system to the controlling shareholders does not represent a *rara avis* in our continental legal scene but instead a natural derivation of the position of power and consequently the fiduciary nature that controlling shareholders hold in the company. Controlling shareholders have a duty of loyalty in our legal system. At this point we shall leave out of the discussion the question of whether this duty of loyalty is organic or merely contractual in nature, based on the grounds that the contract incorporates a general good faith clause (v. arts. 1258 and 7.1 of the Spanish Civil Code). What we would like to point out is the fact that the legal systems in our geographical environment are resolutely advancing towards acknowledgement of a duty of loyalty on the part of controlling shareholders[36].

## § 9. Insufficient Body of Litigation on the Subject of Duty of Loyalty.

If we examine the case law experience in Latin American countries, and naturally that of my own country and even of other neighbors on the European scene as well, we shall find there is extremely little litigation on the subject of duty of loyalty. The cases found in case law books are few, and on the contrary such books are full of cases related to suits contesting corporate resolutions. And this should worry us because any restriction of legal cases undermines the effectiveness of all measures and threatens to leave the permanently insufficient legislative indications seriously incomplete. As I have already insinuated, the dearth and weakness of our legal systems in this field is due to a large extent to the lack of opportunities judges have been given to build up a stock of precedents and guidelines in respect of unlawful management[37]. As a result, both from the point of view of effective deterrence and of the need to go building up a stock of precedents capable of providing good quality legal information and boosting the advance of the

[36]In Germany, for instance, even when it is postulated that they are not accountable for mismanagement or breach of the duty of care, their liability for breaches of duty of loyalty is widely upheld (*Lutter-Hommelhoff*, 1995, S 43, Anm. 46, p. 559-560; *Konzen*, 1989, p. 2985 with more indications). There are also indications that a similar tendency is occurring in Italy: v. judgement Cass 26-X-1995, No. 1151, *Giur. Comm.* 1996, II, p. 329 et seq., which is accompanied by substantial comments by P.G. Jaeger (he bases on the good faith duty of the majority shareholders' (art. 1137 CC) a duty of compensation (art. 1137 CC). Spain does not retract from this tendency either (v. *Paz-Ares* 1999, I, p. 1340-1344).

[37]The importance of this aspect has been adroitly highlighted by *Kamar* 1999, p. 887 et seq.: *"shareholder litigation can be cost effective in view of the indeterminacy that characterizes corporate law"*.

Law on the subject, it seems to be absolutely essential to remove the obstacles currently preventing this litigation. These obstacles basically spring from three circumstances: (i) the high level of capacity required to bring the director liability action ("*acción social de responsabilidad*"); (ii) the opaqueness of the conflicting situations; and (iii) the difficulties of proof confronting shareholders. I shall now go over each of these aspects in brief.

### 9.1. Capacity of Individual Shareholders to Bring the Director Liability Action.

The extreme difficulty confronting shareholders over making director liability effective stems from the infuriating formalities involved (any shareholder wanting to initiate legal proceedings must first obtain a resolution from the General Meeting denying the company to bring the action) and from the high share participation our laws stipulate for the possibility of shareholders being eligible to bring derivative suit: 5% according to Spanish (art. 134 of the SCA), Brazilian (art. 159.5 of the CA) or Argentinean legislation (art. 276 of the CCA); 30% according to Peruvian (art. 184 of the General Company Act) or Mexican legislation (art. 163 of the GCA), even though Mexico has "cut" the demand to 15% in the recent 2001 reform (v. art. 14 bis V d) Securities Market Act). Where public companies are concerned, in all cases we come up against virtually insurmountable barriers. The prototype minority shareholder who is a victim of the infringement by directors of their duty of loyalty never possesses a 5% holding and much less so a 30% of the capital. The truth is that it is hard to credit the fact that this bunkering of the insiders has managed to persist for such a long time. In our opinion, if there is a genuine wish to open up a gap in the impunity prevailing and effectively multiply the likelihood of this disloyal conduct being sanctioned, it will be absolutely peremptory that the abovementioned restrictions are revoked. The means for doing this simply consist of legitimizing the individual shareholder to make him or her eligible to bring action regardless of what the Shareholders' Meeting decides and independently of the percentage of share capital he or she holds[38]. The objection raised that this would encourage strategic litigation is neutralized in the field of disloyalty by appealing to the Mandeville fable: "private vices, public virtues". Even though the motives may not be too above board, the result is the important thing: increasing the control over disloyalty, increasing deterrence and enhancing this public good represented by case law

[38]This is the traditional situation contemplated in American legislation and, with limitations - as individual shareholders may only bring action in cases of fraud affecting the minority or when a shareholder's individual right is affected - in British Law (v. *Gower et al.* 1992, p. 482 et seq.).

doctrine. This does not mean to say, however, that certain precautions should not be taken to discourage strictly flippant litigation.

Our proposal belongs to a line of tendency that is just beginning to be glimpsed on the continental European scene in the wake of the academic criticism of such a restrictive *status quo* prevalent everywhere (the contribution by *Ulmer* 1999, p. 290 et seq. stands out in this respect). The most articulate initiative is contained in the corresponding recommendation of the report recently drawn up by the *German Government Panel on Corporate Governance* (July 2001) which includes some fully subscribable indications concerning the procedure to admit legal action. In particular, the shareholder needs a minimum value of stock to be eligible to bring action (the figure proposed is 100,000 euros, although we feel it should be a good deal lower - for example, 10,000 or 20,000) and that for the purposes of avoiding unnecessary, unfounded or harassment actions, institution of proceedings should be made dependent upon a particular admission procedure by the trial court. Prerequisites for such admission of proceedings should be (i) sufficient prospects of success, namely: the availability of facts substantiating any suspected dishonesty or other gross violations of law or the articles of association by relevant members of the management and supervisory boards; (iii) an unsuccessful request to the company to self initiate legal action, and the absence of preponderant reasons on the company's side speaking against the enforcement of the compensation claim; (iii) achievement of a quorum by the petitioners and evidence that they purchased their shares prior to learning about the violations of a duty that entails liability; (iv) should the application to admit the action prove to be unsuccessful, the petitioners must bear the court fees and costs incurred by the defendants; (v) the decision regarding the costs of the case should be made in line with the general rules of procedure. However, given that the shareholders who are successful in a procedure to admit a legal action would have to bear the costs as a consequence of the action's dismissal, they should have been granted a claim to reimbursement of expenses from the corporation. However, costs that were caused by the plaintiffs' improper prosecution of the case should be excluded from such a claim.

Even so, the above proposal does not go far enough. Individual shareholders have scant incentives to initiate legal proceedings because they only benefit from a minute fraction of the gain resulting from their claim. The "tragedy of commons" rears its head once more here and leads onto a problem of underproduction. As is always the case when an activity involves positive externalities, the appropriate thing to do is to subsidize the claimant. This is not necessary in the

United States because the system of attorney contingency fees solves the problem. In our countries we need to come up with some other alternative incentive. The most attractive of the different incentives proposed is by *Black et al.* (2001, p. 569). It consists of granting to the shareholders who have formulated the lawsuit for a small percentage of the damages payable to the company by way of additional compensation over and above the costs of bringing action and managing the case. Something similar, although more incorrect technically and less effective, has been envisaged in the recent Argentinean reform, which allows individual shareholders to apply to be paid the part of the quota corresponding to them out of the damages obtained (art. 75 of the Public Offers of Securities Act)[39].

Perhaps it would not be amiss to also reflect on the possibility of opening up the director liability action to arbitration. This appears to be a particularly opportune measure in countries lacking a specialized commercial judicature or suffering from wide-scale legal delays. In this respect I find the solution incorporated into art. 125 of the Chilean CA worth emulating, which equally coincides with the recommendations of the most reputed experts advocating corporate governance in emerging countries. This would be a matter of ordering, or permitting where appropriate, that an arbitration clause be incorporated into the company's by-laws at the discretion of the shareholder so that he or she could opt whether to take the case to court or to arbitration (*Black et al.*, 2001, p. 569).

### 9.2. Duty of Transparency.

The second part of our proposal in this field consists of setting up a duty of full disclosure on transactions involving conflict of interests. There are several reasons justifying this measure: (i) the disclosure gives shareholders the information they need to sue, claiming a violation of the duty of loyalty; (ii) disclosure, per se, will deter some self-dealing transactions from being completed and will cause the self-dealing transactions that are completed to be fairer to outside shareholders, on average and over time; (iii) if a self-dealing transaction is concealed, and later discovered, it can be much easier to prove a violation of the duty of disclosure than to prove a breach of the duty of loyalty (*Black* 2001a, p. 18-19).

[39]An alternative solution could be to commission an administrative agency with the capacity for bringing liability action, in line for example with the capacity possessed by Spain's *National Securities Market Commission* to contest the

Duties of transparency need to be articulated in a staggered fashion. The following duties need to be imposed: (i) a duty on the part of the director to inform the Board about the transaction he/she intends to carry out with the company; (ii) a duty on the part of the Board to inform the external auditor, the audit committee and, where appropriate, the regulator if the deed concerned is relevant (this is the line taken by the most recent reforms introduced in the Latin American region: v. art. 73 of the Argentinean Public Offers of Securities Act, art. 14*bis* 3 V of the Mexican Securities Market Act)[40]; and (iii) a duty on the part of the Board to consign the corresponding information, in appropriate detail, to the Annual Report so that shareholders have sufficient news about "risky traffic"[41].

The communication must be followed up by verification by the external auditors. The first step is for them to audit all the authorized operations if in fact they appear in the Annual Report; the second is for them to report to the shareholders thereon; and the third, that they investigate whether any operations have been carried out that were not communicated or authorized. As Professor *Bernard Black* suggests,

> "[The] company's external auditors should review annually all non-trivial related party transactions and provide the shareholders with a report identifying all significant transactions and confirming that, to their knowledge, all transactions required to be submitted for approval by the company's non-interested directors and by the company's non-interested shareholders have been so approved.

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corporate resolutions of listed companies. This is however a second-best solution, for agency incentives to act are weak and often vulnerable to political pressure (for a discussion on this measure v. *Scott* 1999, p. 36).

[40]The initiative involving the auditor being informed is an old standing idea of French Law (v. art. 103 II of the *Loi de sociétés commerciales*).

[41]The same line of measures is contained in the *Testo Unico* and the *KontraG* and, prior to that, a virtually equal provision was contained in art. 10.3 of the amended proposal for the Fifth Directive. In our country, the proposal was implicit in the *Olivencia Report* 1998, 8.2 *in fine* and is now incorporated in art. 35 of Act 24/1988, on the Securities Market, through the amendment contained in art. 32 of the *Draft Finance Bill* currently being processed. This precept reads as follows: *"Las sociedades emisoras de valores admitidos a negociación en algún mercado secundario oficial deberá incluir necesariamente en su memoria de cuentas anuales y en las informaciones semestrales a que se refiere el párrafo segundo del presente artículo, información cuantificada de todas las transacciones realizadas por la sociedad con personas vinculadas.// A estos efectos se entenderá por personas vinculadas a los accionistas con participaciones significativas, los administradores y directivos de la sociedad, así como cualquier otra persona física o jurídica que actúe por cuenta de éstos, que pertenezca a su grupo, o que actúe con ellos de forma concertada.// Por transacción se entenderá toda transferencia o intercambio de recursos, obligaciones u oportunidades de negocio entre la sociedad, incluido su grupo, sujeta a la obligación de información periódica y una o más personas vinculadas, con independencia de que exista o no un precio para esa operación.// Esta información habrá de facilitarse en la forma que determine el Ministerio de Economía o, con su habilitación expresa, la Comisión Nacional del Mercado de Valores, con indicación del tipo y naturaleza de las transacciones efectuadas y de las personas vinculadas que han intervenido en ellas. No obstante, el Ministerio de Economía determinará las transacciones sobre las que habrá de facilitarse información individualizada, en caso de que aquéllas fueran significativas por su cuantía, o relevantes para una adecuada comprensión de los estados financieros de la sociedad."*

Ideally, the external auditors should also report on whether, in their judgement, any non-trivial related party transactions were not on arms-length terms. As a practical matter, such a requirement would ensure that the auditors were consulted prior to the completion of the transaction, to ensure that they were satisfied with its terms. This would provide a further check on the fairness of the transactions". (Black et al. 2001, p. 600).

### 9.3. Burden of Proof of Disloyalty.

The last mechanism facilitating litigation we need to weigh up concerns the burden of proof. At the appropriate point we shall confirm the tendency of our legal traditions to invert the burden of proof in the entire field of director liability and we shall argue the point for the need to avoid this shift of the *onus probandi* in cases of mismanagement or infringement of the duty of diligence (v. *infra* 13.2). Notwithstanding, in our view this tendency is laudable in the field of disloyalty as another part of the stringency policy we advocate, for the purpose of offsetting the position shareholders find themselves in which is lop-sided where information is concerned: direct monitoring of the director by the shareholder may be prohibitively costly and often require expert knowledge[42]. As a result, in our opinion it is in any event advisable to formulate this rule expressly in the terms provided by art. 77 *in fine* of the Argentinean Public Offers of Securities Act in the wake of the 2001 reform: "*en caso de duda acerca del cumplimiento del deber de lealtad, la carga de prueba corresponde al director*"[43] unless the action has been ratified by the General Shareholders' Meeting.

## § 10. Insufficient Volume of Sanctions.

The third dimension on which the legal system of duty of loyalty should be articulated refers to sanction volume or size. As we can easily understand, the policy of stringency we advocate is aimed in this plane at compounding the ordinary system of sanctions envisaged in our laws, which goes no further than lay down the obligation to repair the damage caused. The rationale for this part is easy to see from the angle of the economic theory of sanctions, which - in extreme synthesis - rests on the inverse ratio between the likelihood of detection and the magnitude of the penalization, with a view to successfully achieving optimum prevention or deterrence (v. from the ground-

[42]For a more detailed economic justification of these pleadings in fiduciary relationships, v. *Cooter & Freedman* 1991, p. 1055-1056 and 10769-1071)

breaking work of *Becker* 1968, p. 169 et seq. and *Stigler* 1970, p. 526 et seq. to the abundant literature reviewed by *Cameron* 1988, p. 301 et seq.). Consequential with this and going from the basis of the indisputable premise that contraventions of the duty of loyalty are normally committed in a discreet and even camouflaged manner, the preventive potential of the threat of only having to settle the damages inflicted on the company could prove to be too small, more so if we bear in mind the enormous difficult there is over proving them. It is therefore necessary to raise the cost of the sanction to offset the lower likelihood of detection and the consequent difficulty of persecuting violations of the duty of loyalty. In the case of mismanagement, where there is a higher likelihood of detection, we shall see that this is not necessary (v. *infra* 14). In the case of misappropriation, a policy of greater penalization becomes worthwhile. There are essentially three possibilities open to us for increasing the magnitude of sanctions in private law - leaving aside for now an examination of the criminal sanctions for the most serious cases: (i) paying back the enrichment; (ii) punitive damages; and (iii) actual general remedies.

### 10.1. Disgorgement: Restitution of Undue Enrichment.

The first of the possibilities mentioned can be intuitively understood as a requisite of commutative justice. It simply consists of forcing the director responsible to refund the profit he/she has gained as a result of violating his/her duty of loyalty. Thus - adding on restitution of the enrichment unduly obtained to the indemnity for the losses incurred characteristic of director liability - is in fact a way of achieving the desired aim, to raise the price of disloyalty[44]. It is therefore surprising that the corporate law of our countries expressly contemplated this possibility, although some exceptions do definitely exist (v., for instance, art. 42.7 of the Chilean Company Act). And it is surprising because - as we said earlier - it comes as an elementary requirement of

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[43]In the disloyalty field the Argentinean regulation replicates the regulation laid down generally, therefore including cases of negligence, by **§** 93 (2) of the German *Aktiengesetz*.

[44]The economic rationale for disgorgement in cases of violation of the duty of loyalty has been studied in these terms by *Cooter & Freedman*, 1991, p. 1045 et seq.; in other terms - deeming that it can lead to overprecaution in socially optimum conduct - *Easterbrook & Fischel*, 1993, p. 441-443. However the argument is not a convincing one. They consider that this would be justified if we were seeking unconditional deterrence, but this is not always the case as the company could do the contracting. But even when unconditional deterrence is not being sought, we must bear in mind that the likelihood of detection is never total (it is always less than one) and this means that adding the obligation on to restitution does not lead to unconditional deterrence but rather to a conditional type of deterrence adapted to the one laid down by the parties. For the rest, the rationale for ownership is what must be taken into account here, as *Portellano* stresses.

distributive justice. An explanation for this anomaly must once again be sought in the fact that the entire directors' liability system is designed on a model of negligence.

Even so and in spite of the clamorous silence of our corporation laws on this point, we consider that our private law systems provide a broad enough base to extend the sanctionary apparatus of the undue enrichment doctrine to the hypotheses we are expounding here. Most definitely such extension is perfectly doable in Spanish Law, as brought out by the specialized doctrine whose recent efforts have been aimed at seeking ways to oblige disloyal directors to pay back the company the benefit they could have achieved through violating their fiduciary duties. From the positive legal point of view, the method encountered has been to apply an analogy to all or almost all of the violations of the duty of loyalty (conflict of interests, business opportunities, insider trading, etc.) of the rules contained in the legislation on partnerships (v. arts. 1,683 of the Spanish Civil Code and 136 of the Spanish Commercial Code), which usually provide restitution of undue enrichment in the event of violation by a partner of his or her duty of non competition - a duty, we should explain, that derives from the general duty of loyalty (v. *Paz-Ares* 1991, p. 1420-1421; in greater detail *Portellano* 1995, p. 131 et seq.; a similar orientation, *Llebot*, 1996b, p. 70; in German Law, in some cases an *Erstanttungsanspruch* is also admitted: v. references in *Abeltshauser* 1988, p. 424-426). As was to be expected, this solution is also advocated in the legislative proposals for emerging countries[45].

### 10.2. Punitive Damages and Penal Clause.

In spite of the foregoing, we cannot place too much faith in the preceding measure either. The method that can really bring out effectiveness is undoubtedly legal articulation of a system of "private fines", which increase the volume of sanctions in an open and publicly communicable fashion. This, in a word, constitutes the rationale for punitive damages to which some legal systems resort to prevent infringements of the duty of loyalty in particular and misconduct in general (v., generally, *Landes & Posner*, 1987, p. 160-161; *Polinsky & Shavell* 1998, p. 500 et seq.). Our

[45]Remedies for transactions involving a conflict of interest should be specified in the law. The insider who acted while in a conflict of interest situation should be liable for the losses suffered by the company, including lost profits that could have been obtained by contracting on better terms with another party. In cases where it is difficult to prove loss to the company, but possible to show profit to this insider or his family members, or affiliated persons, the insider should be liable up to the amount of profit (*Avilov et al.* 1999, p.29).

proposal on this point consists of introducing an ad hoc legal provision that, for cases of disloyalty and provided misconduct is proven, provides the obligation to pay the company an additional sum for the amount resulting after multiplying the amount obtained for damages and undue enrichment by a set coefficient (of between 1.5 and 5 for example). The coefficient to be applied on a case-by-case basis shall be selected by the judge as a function of the seriousness of the conduct.

I am aware of the resistance this proposal will encounter amongst Spanish and Latin American attorneys who are more zealous of our legal tradition. For many of them punitive damages represent the incarnation of foreign institutions which are impossible to marry up with alien principles. Notwithstanding, I believe that this type of concern will eventually disappear. I am not saying this because I have detected a stream of opinion advocating the transplant or import of the particular figure in some parts of the region (perhaps the most eloquent episode is provided by the new Civil Code Draft in Argentina, which has opened its doors to punitive damages in the section on tort law), but because I believe my proposal is perfectly coherent with our private law system. To discern this we need to recall the exquisitely contractual nature of director liability and, as a result, place the discussion in the field of contractual liability. It is then that we will realize that the tables have turned for the discussion. Punitive damages in the contractual field, rejected in Anglo Saxon Law, are however admissible in Continental Law (v. arts. 1,152-1,155 of the Spanish Civil Code). Now, there is no question as to whether companies are entitled to incorporate penal clauses into their articles of association in order to guarantee fulfillment of duties of loyalty (arts. 1,152-1,155 of the Spanish Civil Code). There would be nothing surprising over a firm that made an initial public offering (IPO) in order to maximize the selling price of its shares deeming it advisable to offer to pay a penal clause as bonding for its loyalty commitments. In fact, when a particular Spanish firm went public it did something similar (the *Azkar* case). And with all this as it stands, what would be the sense in lodging objections to the Law doing this, complementing a contract that investors are not in a position to do?

### 10.3. General Remedies.

There is no need to remind you here that, in addition to the sanctions characteristic of the liability system referred to in preceding paragraphs, there are always the actual remedies: actions involving application for annulment, dismissal and removal

## IV. LIABILITY FOR NEGLIGENCE. A MORE INDULGENT VIEW.

### § 11. Bases for Treating the Subject.

As we said at the beginning of this presentation, the unitary approach to the director liability system in our legal systems has given rise to two errors. One a defect in the treatment meted out to disloyalty and the other an excess in the treatment given out to negligence. We have endeavored to combat the error of defect with a policy of stringency. We shall now try to correct the error of excess by defending a policy of leniency. The reasons why we back indulgence or a benign approach to designing the legal system for liability for mismanagement were discussed at sufficient length in the second part of this study (v. *supra* § 3-6). They can be summed up as follows: (i) existence of a certain natural aligning of incentives for directors with shareholder interests in this field making it possible to assume that negligent conduct only represents a moderate risk for the company; (ii) existence of disciplinary or enforcement mechanisms provided by market forces, which means it can be assumed that there is no special need to fall back on legal protection instruments; and (iii) existence of enormous uncertainty over the judgement of negligence, giving rise to considerable costs for the company in terms of overdeterrence or overcompliance (escalation of Board compensation; difficulties in recruiting quality directors; excessive precautions in business decision making; conservative industrial strategies, etc.).

The task now facing us consists precisely of exploring ways in which to introduce or articulate this policy of leniency in the interstices of our legal systems. We have indicated that a policy of this kind is justified by the need to correct the excesses of the traditional doctrine on director liability for negligence. The dimensions in which we come across these excesses are similar to those where we previously encountered defects: (i) the dimension related to the matter subject to the judicial control of negligence; (ii) the dimension related to the incentives existing for taking legal action; and (iii) the dimension related to the sanctions that should be levied on the directors who commit mismanagement offenses. I must confess that this is more an intuitive assessment, as the evidence I have is not systematic but simply anecdotal and refers exclusively to my country. I do not mean by this that examples abound in case law books, even though they have increased substantially since 1989. What I do mean is that there is a growing impression that directors are subjected to a high liability risk, and evidence of this is perhaps to be found in the rapid expansion experienced by directors and officers civil liability insurance in recent years. The sense of danger is definitely linked to the modernization and internationalization of our economy, but also to the signs of hardening attitudes sent out by legislators in the wake of the 1989 reform of the Spanish Companies Act (suppression of the exemption for ordinary negligence; consecration of the inversion of the burden of proof; extension of joint and several liability; amplification of the capacity of bringing director liability action; etc.). The doctrine has also contributed to this process by favoring a highly stringent interpretation of the legal regulations (vertical extension of joint and several liability, very strict definition of standards of diligence in line with criteria similar to professional activities, etc.).

Taking this background as starting point, we shall now analyze some formulas at our disposal for mitigating the problems and, in short, for cutting down the excesses.

**§ 12. Excesses in the Field of Matters Subject to Legal Scrutiny.**

The stringency of the most substantive rules of director liability for negligence probably stem from strictly legal prejudices or, if you prefer, from certain traits of the traditional legal culture that we could associate with formalism, rationalism and centralism. The formalism and its congenital tendency of judging reality according to categories of form has determined the categorisation of the business management and supervisory activities of the directors into the legal concept of "professional activity" and, from this platform, into their performance being subjected to the standards of conduct drawn up for this sector (mismanagement equates to malpractice). The rationalism and its intention to build up more geometrical laws has led to director liability rules being drawn up with compass, exactly carrying over this field the general criteria concerning the diligence required in the fulfillment of the obligations, as these have gelled in our codes based on Roman Law tercets (v. art. 1103 of the Spanish Civil Code). Legal centralism - disproportionate trust in the Law and the equally disproportionate mistrust of the other orders regulating corporate activities - has led to consider that the directors' legal liability is virtually the only mechanism available for guaranteeing that firms are managed properly. All of these circumstances - which I have generally expressed in exaggerated terms - explain the substantive properties of the liability for negligence system we now have in place and they are precisely what makes it more damaging. The considerations that follow endeavor to take into account aspects that do not always appear to have been taken into account before - the particular circumstances in which the business decision-making process is carried out and the non legal mechanisms that contribute towards its developing correctly - rating the opportunity of narrowing down the objective field and the subjective extension of the judicial control over negligence.

### 12.1. Discretionality of Business Decisions: An Area of Immunity.

The most direct way of achieving the aim pursued consists of lowering the demandable diligence standard. All this needs is to re-establish the so-called "Roman privilege" by virtue of which directors would only be liable for gross negligence. This is the solution adopted for partnerships by our Commercial Code (art. 144) and was also the method used in the Spanish 1951 Company Act, which exonerated directors from liability who had committed minor or ordinary negligence against the general rule on demandable diligence in the fulfillment of obligations laid down in the Civil Codes (v. art. 1103 of the Spanish Civil Code). The reasons alleged in the doctrine for justifying this anomaly in the system - "the difficulty of discerning whether a damaging operation is the result of negligence or business risk and the difficulty of recruiting valuable directors if they will be exposed to a risk of liability for ordinary negligence" (*Garrigues,* 1976, I, p. 164)[46] - coincide substantially with those that back the policy of leniency we put forward. However, this does not mean that this is the most appropriate way for moving ahead in the target we have set ourselves. The problem lies in its overinclusive nature[47]. Because it operates on the model of diligence, the reduction applies to all of the directors' activity and, consequently, to the activity falling outside the area of uncertainty as well: fulfillment of specific duties provided by Law and by the articles of association (for instance, call of Board Meetings, drafting of accounts, informing to regulators, etc.); monitoring situations of conflict of interest within the company, etc. And the truth of the matter is that there is no reason whatsoever for the exemption to be extended to these fields because there the directors' activity is not subjected to any high risk of error and this is precisely what justifies the leniency.

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[46]Case law equally captured the sense of privilege: *"la calificación de culpa que el legislador ha establecido en el artículo 79.... más que producto de una concreta técnica legislativa, es consecuencia de una inequívoca intención legislativa, al objeto de evitar la resistencia a aceptar el cargo de administrador que se produciría si la responsabilidad se extendiera a las faltas leves de diligence"* (STS 13-X-1986, Ar. 3849)

[47]Our doctrine broadly criticised the precept, but for grounds related more to formalism and centralism as mentioned above (v. *Girón,* 1960, p. 921; *Quijano,* 1985, p. 142; etc.).

The way to follow specifically consists of isolating the particular area of director activity in which liability may prove more costly for the company and its shareholders. This area is undoubtedly the field of business decisions in which the decisions taken affect the business operations of the company, because the uncertainty over the judgement of negligence is extreme. Having made this isolation, the right way to proceed is to protect the *technical discretionality of directors* and therefore the immunity of the decisions they take in this field of legal control. The proposal is equivalent to incorporate the *business judgement rule*, early developed by North American case law, into our legal systems. The reasons justifying removing this field from judicial scrutiny should be familiar by now: (i) there is no consolidated *lex artis* capable of serving as reference for judging the decisions; it does not exist and it would not be good if it did, given that the expected practice in this field is innovation and risk assumption; (ii) judges are not well prepared for adopting this type of decision and, in addition and in any event, it does not appear to be wise to substitute business decisions for judicial decisions (aggressive judicial attack on managerial error would be equivalent to replicate the management and intervention costs of public companies); and (iii) an additional risk is also produced related to selection bias, since lawsuits tend to proliferate at times when results have been poor and it may therefore prove difficult to resist the tendency or temptation to think that the origin of the losses that appeared *ex post* lies in the negligent decisions adopted *ex-ante* (for a good approach to this issue in our doctrine v. *Llebot* 1996, p. 73-84; 1996b, p. 62-65; and in the original literature, involving different points of view, v. *Clark*, 1986, p. 125 et seq.; *Eisenberg*, 1990, p. 945 et seq.; *Fischel*, 1985, p.1437 et seq.)[48].

Recent press articles reported that a group of small shareholders of Banco de Santander Central Hispano had brought a liability action against its Board of Directors for the damages caused by the "disastrous investments made by the Bank in Argentina" which, according to information included in the lawsuit, entailed a loss of 1,792 million euros for the company. (*El Mundo,* Monday, April 1st, 2002, p. 25). I would ask readers to stop a while to think about the difficulties companies would have to handle in a country where lawsuits of this nature thrived. What usually happens is

[48]The business judgement rule has been coded and consolidated in letter (c) of section 4.01 of the *Principles of Corporate Governance* of the American Law Institute in the following terms: "A director or officer who makes a business judgement in good faith fulfils the duty under this Section [this section that formulates the general duty of diligence} if the director or officer: (1) is not interested (...) in the subject of the business judgement, (2) is informed with respect to the subject of the business judgement to the extent the director or officer reasonably believes to be appropriate under the circumstances; and (3) rationally believes that the business judgement is in the best interests of the corporation" (ALI, 1996, I, p. 139).

that in the end a *principle of caution* prevails, which was what occurred in the famous ruling of the Spanish Supreme Court over the case of the *San José* papermakers (v. STS 11-5-1991 (Ar. 3637). A decision to buy in paper pulp at a good price in exchange for an anticipation of funds was considered negligent because subsequently the firm that ought to have delivered the order, which certainly was in difficulties, was declared bankrupt. The judge pointed out that “operations of this kind cannot be carried out without adequate guarantees" and, in short, that the objection stands because "pursuant to the differential obtained and the risk factor assumed, from a principle of caution that should dominate all business management, the operation [...] did not respond satisfactorily to optimum purchase conditions". All I need to do now is remind you here that “the concept of a prudent person is not desirable in the field of business management. On public policy grounds, innovation and risk assumption are to be encouraged” (Sorensen, 1988, p. 573, note 66).

The objection frequently raised to this proposal in my country - and I believe in the other Latin American countries too - is a cultural one. This would once again involve a question of importing an American invention that is incompatible with our tradition. The objection could again be replicated by appealing to the path dependence underlying the argument of the incompatibility with tradition. But in this case there is more to it than that. It could be argued that if creating a form of immunity for management errors is justified anywhere, it is precisely in our countries, and this because (i) the judges are less sophisticated, less familiarized with the intricacies of business and financial operations and, furthermore, they have a more bureaucratic and formalistic tendency; (ii) the managers of the companies, require even less than in the Anglo Saxon environment the judicial scrutiny because they are subjected to the watchful eye of the controlling shareholders (remember that in our environment capital markets have a highly concentrated ownership structure[49]); and (iii) because it is above all in our traditions where there is a greater need to create the conditions in which a risk and innovation culture can develop.

In fact, on many occasions our judges find themselves having to take this path. The shrewdest decisions of our judges are aimed in this direction. A recent ruling of the Provincial

[49]This is so much the case that one scholar put forward the theory that the ownership concentration occurring in the countries in continental Europe may be a consequence, not so much of the lack of protection for minor shareholders against the risk of expropriation (which is the basic idea of the research currently most accepted in law & finance and which has inspired our rationale), but rather of the need to set up a direct control over mismanagement (v. *Roe* 2002, p. 26-37). The conjecture contained is that "if the risk of managerial error varies widely from nation-to-nation, or from firm-to-firm, ownership structure should vary equally widely, even if conventional corporate law tightly protects shareholders".

Court of Córdoba, is particularly eloquent on this, in spite of the fact that it belongs to an area where there is little industrial development. This sentence advocates acknowledging that directors deserve "a certain privileged status where liability imputable for their organic performance before the company is concerned, so that the integrity of their personal wealth is not endangered". Should this opinion be contested the Court adds "we would be converting director performance into high risk work [...] Loss can be attributed to a wide range of factors, the majority of which should not be directly imputed to directors' management as - particularly when they are partners - they are the first to be interested in economic success. It should be borne in mind that on almost all occasions the decisions a company requires imply assuming risks that are precisely the factor that justifies profit" (SAP Cordova, 27-1-1997; ARC, 1997-1, p. 94)[50]. As regards the rest, this is the tendency we note in the most recent reform movements in the continental laws in this field and even in the field of legislation in emerging countries. In this respect, Germany has probably been the country that has traditionally put up the greatest resistance to the business management rule, but in the end it has had to succumb[51].

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[50]On other occasions the same conclusions are reached by considering that cases of "the slightest negligence that are difficult to assess in business operations " should be understood to be excluded (STS of October 11, 1991; SAP Madrid 6-24-1993; RGD 589 (1993), p. 10532; SAP Toledo 12-12-1994; AC 1995-1, p. 780).

[51]Worth highlighting in Italy is the ruling by the *Corte Cassazione* of XI-12-1965 (No. 2359) and in doctrine, *Bonelli* 1991, p. 361 et seq.; in Switzerland, *Grass* 2000, p. 3 et seq.. Even the most reluctant country, Germany, ended up by succumbing. The landmark was the decision in the *Arag* case taken by the German Supreme Court, which was followed by the well-known study by Professor *Peter Ulmer* suggesting that a anew subsection should be added to § 93 of the *Aktiengesetz* in the following terms: *"Eine Pflichtverletzung liegt nicht vor, wenn der Schaden durch unternehmerisches Handeln im interesse der Gesellschaft auf der Grundlage angemessener Informationen verursacht wurde, aun wenn dieses Handeln sich aufgrund späterer Entwicklungen oder Erkenntnisse als für die Gesellschaft nachteilig erweist".* The *Ulmer* proposal was enthusiastically accepted in the *Regierungskommission* (2001), No. 70. In the "general principles of company law for economies under transition" legislative consecration of the business judgement rule is equally advocated: "There is good reason to limit the circumstances in which members of a company's management organs are liable for actions taken in good faith and without a conflict of interest. Business decisions necessarily involve risk, and must often be taken based on limited information. Some risky decisions will prove highly profitable, while others will look foolish with the benefit of hindsight. If managers can be found liable for decisions that look foolish in hindsight, they will be reluctant to take risks. Moreover, judges are not very web placed for assessing whether a business decision that has turned out badly was reasonable at the time it was taken" (*Avilov et al.*, 1999, p. 40; v. also *Black et al.* 2001, p. 563). This is the tendency also seen in the most recent reform work in Australia and New Zealand, which clearly opts for codifying the business judgement rule (v. information in *Farrar* 1998, p. 49 et seq.). An interesting proposal is formulated int the Report "Directors´' Duties and Corporate Governance" by *The Attorney General's Department to the Treasury and the Corporate Law Economic Reform Program Proposals for Reform*, which literally reads: (1) An officer of a corporation is taken to meet the requirements of subsection 232 (4) and the general duty of care and diligence in respect of a business judgement made by them if the officer: (a) exercises their business judgement in good faith for a proper purpose; does not have a material personal interest in the subject matter of the business judgement; (c) informs themselves about the subject matter of the business judgement to the extent the officer reasonably believes to be appropriate; and (d) rationally believes that the business judgement is in the best interest of the corporation. (2) In this section "business judgement" includes any decision to take or not to take an action in respect of a matter relevant to the business operations of the corporation. (3) Subsection

Naturally, removing business management activities from judicial scrutiny must be contingent upon compliance with a number of provisos and, in particular: (i) that directors obtain reasonable information on the decision; (ii) that they follow the established form-related procedures; and third and above all (iii) no conflict of interest or personal interest exist in any collateral consequence of the decision. I would not seem necessary here to go into the scope of this.

**12.2. Exception: the "Duty of Independence".**

If the directors adopt the decision in a situation of conflict of interest, we are in the realm of duty of loyalty. Notwithstanding, it is advisable to exclude from the benefit of immunity the cases where directors are called to supervise transactions that may involve conflicts of interest between the direct managers and the company. Typical cases of this are (i) fixing retributions of other directors; (ii) defensive measures in battles over control; (iii) approval of transactions between related parties; (iv) greenmail and repurchase of treasury stock; etc. These are all mixed cases as they entail business decisions (which should not be intervened) at the same time as possible conflicts of interest (subject to very stringent rules). For these cases a *tertium genus* has been proposed which would stand midway between the duty of diligence and the duty of loyalty: the *duty of independence*. The idea with this is to draw up criteria helping us to answer the following question: how would a truly independent advisor have acted? In principle the logical procedure here would seem to be an intermediate system: not as lenient as liability for negligence nor as stringent as liability for fraud (for an analytical development of this system v. *Palmiter*, 1989, p. 1351 esp. 1446-1448; I believe that *Black* follows a similar line when he proposes a *duty of special* care: v. *Black* 2001, p. 26-28) [52].

**12.3. The different Positions of the Director.**

The leniency policy that we have been maintaining also calls to limit or *moderate the subjective scope of the director liability for violation of the duty of care*. The issue is, once again,

(1) does not operate in relation to any other provision of this Law or any other Act or any Regulation under which an officer may be liable to make payment in relation to any of their acts or omissions as an officer".

[52]Remaining outside this field are strategic decisions concerning diversification, overinvestment, overexpansion (empire building), reluctance to take on profitable but job-threatening risks, etc. Even though they undoubtedly involve opposing interests, they belong to the core of the business judgment rule. The way to combat them is by creating a corporate culture around the principle of firm value maximization and by adopting appropriate policies and incentives (v.g.r.: stock options) for neutralizing their risks (v. *Jensen* 2000).

that the law should not be interpreted or made without taking into account the reality. In this area there are several issues to note:

**a)** The first one relates to the increasingly differentiation of functions within the collegial administration body, in which internal directors (with executive functions) and outside directors (with control functions) coexist in a process that, in the last instance, derives from the progressive consolidation of the so called *supervision model* and to the correlative decline of the traditional models - the managerial model, the representative model and the participative model (v. for a first approach, *Paz Ares*, 2001, p.5 et seq.). That does not obviously mean that the functions of these kind of directors have to be radically separated[53]. But it is indisputable that it determines the necessity of adjusting the duty of care of directors in accordance with their role in the board. This adjustment of the duty of care has several projections; and, without any doubt, the most important one is the one related to the information. Given the existing asymmetry in this point between internal and outside directors, a rule on the reliability of internal information should be set out. According to this rule directors will not be subject to liability when they adopt decisions on the basis of information, opinions and reports of executive commissions and managing directors (*consejeros delegados*), officers and employees of the company, whose ability and credibility do not offer reasons to doubt[54].

**b)** The second remark refers to the joint and several nature of director liability established in all legal regimes of the Latino-American region (art.133.3 of the Spanish SCA; art.158 of the Mexican GCA; art.274 of the Argentinean CCA; art.158.2 of the Brazilian CA; etc.). As is well known, the rule of the joint and several nature of director liability is a direct consequence of the collegiality principle that rules the organisation of the administration bodies, and in this sense is formally irreproachable. However, it is a rule that can not be mechanically applied, "using the compass". Even within its own field of applicability - as is the case of the Board acting as a Board[55]

[53] The advantage of the monistic system shaped in accordance with the supervision model precisely lies in the fact that it separates the functions, but it does not split the responsibilities. And as it can be easily noted, the most effective way to make the control effective is to make the supervision body liable for the management (v. *Paz-Ares*, 2002, p.71).

[54]V. ALI., 4.02, 4.03. If a rule of this nature is introduced in the legislative reform, the distinction between internal and outside directors would not be required. It would only be necessary to consider in a different way for each case what is a "reasonable reason for credibility".

[55]It doesn't have to be said that in view of the collegiality principle that justifies it, the rule of the joint and several liability does only operate horizontally and in no case can it be vertically extended to bodies organically - managing

- this rule has to be adjusted in view of the principle of labour division in those areas in which it is justified from a organisational stand point. In effect, a labour division correctly established has to operate as "firebreak" of the liability, and this is how it is understood by the more alert doctrine (v. *Raiser*, 1986, p.71 and, to certain extent, admitting statutory provision aimed at this result, and among us in *Paz-Ares*, 1997, p.166).

**c)** Finally, the right path lonely initiated by the Argentinean law in the direction mentioned above should be noted[56]. We are referring to the reform of art. 274 CCA operated by Law 22.903, by virtue of which, and notwithstanding the rule of the joint and several liability, "the attribution of liability will be made pursuant to the individual performance in those in cases in which functions would have been assigned on a personal basis in accordance with the statute, the regulation or the resolution of the stockholders' meeting". The article adds that "the resolution of the stockholders' meeting and the designation of the persons that have to develop the functions should be recorded with the Commerce Public Registry as registry for the application of this paragraph". The rule is wise as it considerably reduces the uncertainty, facilities the process of decision-making and, on the last instance, allows to establish more efficient organizations. We imagine that the introduction of this rule may had created feelings of suspicion and found reluctance from those who were not ready to give up the dogma inherited from the joint and several liability. For this reason the Drafting Commission (*Comisión Redactora*) has been forced to specify in its General Considerations (*Consideraciones Generales*) that come with Law 22.903 that "the modification does not imply to reduce or temper the liability of the members of the administration body, but to attend to the

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directors (*consejeros delegados*) and executive commissions (*comisiones ejecutivas*) - or contractually delegated. However, if we make this remark is because we notice a dangerous tendency of stringency in our most recent doctrine, which results tend to enlarge the joint and several liability between delegating bodies and delegated bodies. Such circumstance has the serious consequence that in the event of faults of the delegated bodies, the burden of proof of the lack of negligence is attributed to the delegating body - the Board of Directors - (*Alonso Ureba*, 1991, p.723; *Fdez. de la Gándara*, 1996, p.300; etc.). An approach of this nature is not only economically unbearable but also legally untenable. To correctly approach this issue we should start from an undeniable circumstance, that the delegation of faculties modifies the content of the duties of the members of the administration body: the duty to govern is transferred and only the duties to appoint, instruct and monitor are retained. This has been called the "general supervision function" (*Special Commission* 1998, p.16-17). Therefore, the diligence judgement should be made on the basis of the material tasks of each person (v. *Iglesias*, 1972, p.130-131; *Polo*, 1992, p.465-467; *Quijano*, 1985, p.286-287; *Sánchez Calero*, 1991, p.928-93; and a bit confusingly *Esteban Velasco*, 1995, p. 5914). To judge the delegated body, it should be examined if it diligently complies with its duty of management; to judge the delegating body, it should be checked if it complies with diligence with its supervision duties. Therefore, the fact that we catch the first one in a "failure" does not authorise to, by only this fact, to disqualify the behaviour of the latter. Each of us must face up to our own responsibilities.

[56]And in this direction also the Brazilian Law (art.158.1 LSA).

individual performance (Sic)". However, the truth is that the produced effect is a new erosion of the joint and several character of the liability, which scholars usually deny (v., for example, *Halperín & Otaegui*, 1998, p. 000). We understand that this is undeniable[57] . But there are further issues. If a will to take the initiated trip to an end really exists, an additional step will have to be taken and the formal registration requirements that came with the reform will have to be abandoned. The individual performance has to be the judgement standard when functions have been assigned in accordance with justified criteria of working division[58]. And in this line, the last paragraph aggregated to article 274 I CCA of the old Draft Bill of Transparency (*Anteproyecto de Ley de Transparencia*) was surely not badly directed. It stated as follows: "The attribution of liability will be made in all cases in view of the individual performance of the responsible person"[59].

### § 13. Excesses of Litigation.

On the litigation plane, the policy of leniency we have been defending is aimed at minimizing litigation - and, if possible, at preventing purely strategic or fatuous litigation - whose optimum level we presume is very low. It is true that when the Law is indeterminate, litigation can prove socially beneficial to the extent that it creates the opportunity for judges to detail the Law and thereby help to reduce the legal uncertainty and inadequacies inherent to it. Consequently, there would be room to argue here, as we did when we dealt with the problem of disloyalty, that litigation can be cost effective and socially desirable. In our opinion, however, this argument is not very convincing where negligence is concerned. This is because in this field - especially when it refers to business decisions - the information judges can provide is of little value and highly qualified by each individual case. We suspect that the benefits that could be obtained in terms of development of legal doctrine and reduction of liability of risk may not justify the substantial cost of shareholder litigations. Our motto must therefore be to minimize litigation and of course prevent fatuous litigation. We have several ways for doing this.

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[57]And, in this sense, we have to share the opinion expressed by *Gagliardo*, 1997, p.535: "according to the measures introduced by the reform (art. 274 sec. par.) the effects of the passive joint and several liability of legal origin are limited or circumscribed. This determines the right regulation solution".

[58]The collegial liability will only operate when the criteria of working division are not justified and we face a trick to transfer the liability to third parties in order to avoid it.

[59]I have to thank Dr. Odriozola and Dr. Villegas because they cleared the doubts initially brought to me by this rule.

### 13.1. Restricting the Capacity to Bring Liability Action.

For the same reasons we have been expounding, it would not seem necessary at this point to admit the action promoted by an individual shareholder and, in a general manner, grant the capacity to claim before the Courts to any shareholder and still less to subsidize his/her litigation in the terms we have proposed in respect of the demand for liability for breach of the duty of loyalty (v. *supra* 9.1). In this case it is appropriate to preserve our traditional systems of bringing company liability action (*acción social de responsabilidad*) and, in particular, to make the capacity to bring a director's liability action conditioned to the - individual on grouped - possession of a significant stake in the company (5% for example)[60]. The need to hold a significant stake in the company can also serve to prevent a large part of the fatuous or strategic litigation carried out for aims that are not too above board. The significant stake can in fact be taken as an indication or proof of a genuine interest as shareholder.

### 13.2. Burden of Proof.

Another indirect way to reduce litigation consists in raising potential plaintiffs' costs of proof and, for this purpose, the possibility of putting them in charge of the burden of proof has to be considered. In this way the liability risk of directors is lessened. The criterion that has finally prevailed in the Spanish practice and in certain Latin American countries does not accord, once again, with the requirements of a policy of leniency and with the economic rationality that supports it. This is because it imposes directors the burden of disproving the accusations of negligence that they may be subject to. "The plaintiff - is generally mentioned- will only have to claim the breach by the director of the obligations of its office". The defendant has to prove "the lack of negligence, that he or she used the available means to prevent performance of the damaging measure" (*Fdez. de la Gándara*, 1996, p.22; *Alonso Ureba*, 1991, p.690; *Machado*, 1997, p.326; etc.)[61]. An approach of this nature, certainly based in the generosity with which our Courts invert the burden of proof in the

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[60]What appear to be excessive on the other hand are the capital stakes required by some Latin American laws like the Peruvian or the Mexican that demand 33%.

[61]It is easily understandable that this doctrine is tributary of an institutional culture that defends to maximise the stringency of director liability at any time. It is particularly eloquent the "political - legal" argument of *Quijano*, 1999, p.547 et seq. in support of inverting the *onus probandi*, mainly by the influence of the Preite Report, widely disseminated in Italy.

tort law field, intends to be justified by the idea of the availability and facility of the proof[62] and to be legally based in the regime of the joint and several liability of directors. Regime that can only be avoided by those who prove that did not participate in the approval of the resolution (arts. 133.2 of the Spanish SCA; 274 of the Argentinean CCA; 155 of the Brazilian CA; ...). The paradigm of this position in represented by the German Law, which S 93 II *Aktiengesetz* expressly states that in case of doubt the *onus probandi* corresponds to the directors[63].

However, in our opinion this criterion should be revised. If given any damage suffered by the company as a consequence of a decision of the directors, we obliged them to prove that they have not act with negligence and that they have not breach any duty (unlawfulness), we are aggravating the problem of overcompliance associated with the uncertainty in which directors have to approve their decisions (v. the suggestive thoughts related to the impact of the proof regime in this field on *Calfee & Craswell*, 1986, p.295 et seq.) and favouring the waste on anticipated precautionary measures that may help to constitute proofs in advance ("walls of paper", etc.). The result is once again counterproductive for the social interest. Therefore, we suggest to lead the more consolidated doctrine to the course of the so called *Normentheorie*, by virtue of which each party has to prove the premises of fact of the rule that is favourable to it. In fact, our proposal is very simple; it only requests the effective reestablishment of the general rules of contract law (*incumbi probatio qui dicit, non qui negat*)[64].

It should be stressed that the proposal that we make is perfectly consistent with the rules of the joint and several liability. Such rules establish the joint and several liability of the members of the Board of Directors and subsequently that directors may only avoid the liability it they prove that they haven't contributed and, even, that they opposed to the decision by virtue of which the damaging action was approved; but this may not determine, as is usually done, the conclusion that

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[62]Now recognised in art. 217.6 LEC (directors are typically nearer to the proofs than those who bring the directors liability action).

[63]"Die Beweislastumkehr nah S 93 II 2 geth über den allgemeinen zivilrechtlichen Grundsatz hinaus, wonach der Shuldner die Sorgfältige Pflichterfúllung zu beweisen hat (vgl. SS 282, 285 BGB) und wir von den Gerichten extensiv verstanden" (*Raiser* 1992, pp.113-114).

[64]This principle was included in the old art. 1214 CC, now merged in paragraphs 1 and 2 of art. 217 LEC which support the same idea of art. 1214 CC, by virtue of which the claimant has to prove the facts in which he/she bases its claim. The risk that is currently run is in paragraph 6 of the referred article, which grants the judge with the authority to moderate or correct the general regime of the burden of proof on the basis of the criterion of the "availability and facility to prove".

the *onus probandi* is inverted in the field of director liability. Such provisions have a more limited scope. To notice it we have to take into account that one thing is the proof of the body's liability and a very different one is the proof of the liability of its members. The only issue that the mentioned provisions state is that once the liability of the body has been proved the liability of its members is subject to a presumption. But from this secondary presumption, justified by the impossibility of having access to the secret declarations of a collegial body, a primary presumption can not be obtained. The burden of proof of the body's liability has to be assigned in accordance with the examined general principles, that necessarily take to in charge the plaintiff with the proof of the negligence and with the proof of the breach of the diligence duty of defendant directors (in this respect the remarks of *Esteban Velasco*, 1995, p.5913-5914 result to be very much to the point).

### 13.3. The Settlement as a "Transaction Between Related Parties".

A systematic contemplation of the problem of director liability for negligence requires to also reflect about the settlement. This is an issue that, in our opinion, should be facilitated, but that at the same time has to be surrounded by the appropriate guarantees, since in it a conflict of interest situation that brings loyalty duties of directors may arise. Under this perspective, it seems logic to submit the settlement to the same regime as any other transaction between related parties.

## § 14. Excesses of Sanction with a Fianl *Excursus*.

The last plane on which a policy of indulgence can become effective is related to sanctions. As soon as a sanction consists "simply" of repairing the damage caused, objections could be heard to our own approach which presupposes the existence of an excess of sanction. Those upholding this opinion would basically be viewing the question from the point of view of the compensatory function of civil liability (something which is fairly chimerical owing to the disproportion existing between the possible loss and the assets available) and not from a preventive function - the one we have championed here. This is so because if we examine the question from this angle we shall immediately realize that quantifying the sanction as a function of the damage caused may prove to be counterproductive for the company. We must bear in mind that the directors may well be highly averse to the risk, especially when they stand to lose large amounts of money relative to their personal wealth. The aversion to risk may prove extraordinarily costly to the company as it exacerbates the problem of conservative policies and the squandering on cautions addressed to minimize the liability risk. The reflections given below contain some elements that could serve to offset this problem.

### 14.1. Quantitative Limitation of Liability.

Our first suggestion in this field consists precisely of legally setting up a quantitative limitation on director liability for negligence depending on a multiple of the overall amount of director's annual retribution (5 and/or 10 yearly payments). Naturally, the violation will have to be contingent on a series of elementary presuppositions, such as that the violation of the duty of care is neither conscious nor intentional, that it does not imply personal benefit for the director and is not the result of an ongoing abdication of his/her commitments to the company[65]. The essential aim we are after here with the quantitative limitation of liability is to cut down the extreme aversion to risk that a director would otherwise have to support with the detrimental consequences this could have - as we are well aware - for the interests of the company[66]. We must also bear in mind that the limitation is particularly appropriate when the indeterminance of the law is considerable and there is little likelihood of people being corrupted (the argument was developed by Craackman 1986, p. 78-79). And this is precisely what happens with the duty of care: the legislation governing it is one of the most indeterminate and generic pieces in the legal system and the directors who are subject to it are normally people who do not have motives for acting negligently because doing so - as it has already been reminded - does not bring them any direct benefit (v. *supra* 4). The appeal - the persuasiveness - of the rule of liability limitation lies, in short, in its capacity to set up a compromise between shareholders (that the liability in some way implies a preventive effect without creating powerful incentives for conservative policies) and the interest of directors (to be certain about the maximum amount of their liability and not to be exposed to the danger of having to make disproportionate payments out of their personal wealth, retribution and dedication).

[65]A similar proposal was put forward by Bernard Black for the reform of the *Corporate Governance* in Korea. The formula uses the following terms: *"Articles 399 and 401-402 of the Commercial Code should be amended to provide that the personal liability of an independent director will be limited, in the case on non-wilful breaches of duty non-involving personal benefit for the director or the director's family, to a multiple (such as think?? of times) of the director's total annual compensation from the company (including the value of non-cash compensation)"* (Black 2001, p. 563).

[66]We could cite other additional benefits for liability limitation such as: (i) the possibility of a better legal application of the duties of diligence, as judges are loathe to impose fines they perceive as enormous for infringements that do not have high repercussions on the company; (ii) cutting down litigation; (iii) lowering the cost of the civil liability insurance; etc., but in our view none of them are particularly relevant.

Certainly, it could be argued that this commitment ceases to be necessary once the liability risk has been reduced via the business judgement rule and the measures we suggested above to lower the level of litigation. Notwithstanding, we do not see these initiatives as substitutes, but rather as complements. Although the *business judgement rules* should serve as the primary bulwark of protection for the board, a diligent and prudent director who complies fully with the requisite standard of care may fear that the judge will misperceive the actual facts[67].

The objections that could be leveled at this proposal from the legal angle - (i) that it fails to fulfil the compensatory function expected in liability; (ii) that it proves to be unfair for the shareholders; and (iii) that it is inconsistent with the principles of our legal tradition - are all more apparent than real. To take heed of this we must make three elucidations that are frequently overlooked. The first is designed to remind you that director liability is a contractual liability and, as a result, is not subject to the imperative characteristic of tort law whose fundamental function is to compensate victims (otherwise in this context compensation is less exercisable and less urgent). The second elucidation is that the liability limitation we propose, far from being unfair for shareholders, can precisely be justified on the grounds of equity or fairness, because the potential liability in cases in which it applies would otherwise be excessive in relation to the nature of the directors culpability and the economic benefits expected from serving the company[68]. The third elucidation is to point out that our proposal fits in perfectly with the fundamental rules of our tradition in respect of quantification of the liability for breach of contract. We are referring to the rule that specifies the limitation on the liability to the damages foreseen at the time of drawing up the contract and the rule which acknowledges that judges are empowered to moderate the damages in the event of breach - without malicious intent - of the contracted duties of diligence (included in Spanish Law in arts. 1107 and 1103 of the Civil Code). The rule of judicial moderation speaks for itself. The rule of foreseeableness however is somewhat more complex. In order to understand why I have brought it up in this context, it is worth my while reminding you that one of its most important applications - as the most recent research has demonstrated - occurs in cases where the relationship between performance and counterperformance disappears or is totally de-structured. Pursuant to this, it could be argued in fact that, save evidence to the contrary in the company,

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[67]Precisely for this reason it is also recommended in the principles of corporate governance of the *American Law Institute* in its *Section* 7.19 (ALI 1994, II, p. 240).

[68](ALI 1994, II, p. 241).

directors are not liable for the detrimental results whose potential for damage is totally out of proportion to the benefits and retributions they expect to receive from their work (v. *Pantaleón*, 1996, p. 44-49). And so we can demonstrate *quod erat demostradum*: that there are principles in our private law system that lead to, or are capable of leading to, similar results to those to which the proposal for quantitative limitation formulated here lead.

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working paper available at www.SSRN.com, 2001.