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COMPARATIVE ANALYSIS OF CORPORATE FIDUCIARY DUTIES: DECEPTIVE SIMPLICITY OF THE CONCEPT

More than four centuries have passed since the first corporations ever were established and respectively since the moment the need to regulate them arose. Thus, corporate law has undergone at least 400 years of development. And indeed, if we take a look at corporate law now, it has turned into a distinct area of law with voluminous rules, governing relations between corporate constituents, and an average corporate transaction requiring endless hours of work by a whole team of narrowly-specialized attorneys.

At the same time, if one takes a big picture view of corporate law, one of the first characteristics they would identify is that its detailed rules are a thick net of branches that grow only form a few cornerstone concepts and doctrines. An example of such concepts is the Agency theory. In the context of corporate law, agency theory is an economic theory, that is applied to explain the relationships between shareholders, as principals, and directors, as their agents. A central goal of the agency theory is aligning the interests of the principals with those of the agents. Fiduciary duties serve an important role in contributing to the alignment of such interests by establishing a mandatory rule to act in the best interests of shareholders, clarifying what "acting in the best interests of the shareholders" means and penalizing any conduct that does not correspond to the standards set in a way to ensure that losses resulting from such conduct are greater than gains.

There is an overall consensus around the world that fiduciary duties shall form an integral part of corporate law, yet there are major differences when it comes to the standard of conduct under such duties. This is the question we shall be partially exploring in this article by comparing application of fiduciary duties under Delaware law, on one side, and their application under the laws of Russian Federation on the other.

Overview of Fiduciary Duties under Delaware law

We shall begin our analysis from a brief overview of fiduciary duties under Delaware law and their evolution. The primary statute regulating corporate matters in the state is the General Corporation Law. However, if one takes a look at the statue, they may find only brief references to fiduciary duties and they will definitely will not find a definition of those duties or an explicit rule stating that directors of the corporation are bound by fiduciary duties. The fact of the matter is that corporate fiduciary duties are judge-made.

At the same time, Delaware courts did not invent the idea of fiduciary duties out of blank, the concept of fiduciary duties existed in medieval England in the context of trust law and was enforced there by courts of equity. In 1320s, trusts emerged as tools to evade certain inconvenient legal rules related to inheritance of property. Namely, according to early common law, with certain exceptions, a dying landlord in England was forced to leave his land to the eldest male heir. If the heir to the land was under 21, the feudal lord of the heir took the heir and the land into guardianship. If the lord took reasonable care for the heir, he was allowed to keep all profits from the use of the heir's land until he turned 21. In order to avoid these expenses, a landlord would transfer the land to a small group of persons who would hold the land for the benefit of the original landholder and then for whomever the landholder would designate by will. Such an arrangement allowed to defer the transfer of the land to the heir until

the latter reached the age of 21 and thus allowed to evade fees payable to the lords. The persons who held the land for the landholder were called feoffees.[1]

Initially the arrangement relied on the good will of the feoffees and close personal relations with them. However, not all feoffees kept their promises.[2] This is where the issue of enforcing such legal arrangements arose. After some time, such arrangements begun to be legally enforced by the courts of equity who ruled that ***feoffees owed a fiduciary duty to carry out the feoffor's wishes to benefit the beneficiary (cestuy que use).*** In 1460s, the Justices of Common Pleas described the duties of a "feoffee of a trust" to "plead all pleas and to maintain an action for the land as the beneficiary would want to, but this would be at the costs of the beneficiary". This was essentially the definition of fiduciary duties owed by feoffees (predecessors of trustees).[3]

The concept of fiduciary duties was later developed and applied in different fields of law, as well as in different legal systems. An example of this is their application by Delaware courts in corporate law. What the Delaware Courts essentially did is they took the existing fiduciary duties applicable to trustees and applied them to directors of corporations by recognizing them as trustees. In Lofland v. Cahall, the Supreme Court of Delaware recognized directors as trustees for the corporation they had undertaken to represent and affirmed that a fiduciary relation existed between directors and stockholders. In Loft v. Guth, the Court of Chancery of Delaware, referring to Lofland v. Cahall, stated that ***"directors of a corporation stand in a fiduciary relation to the corporation and its stockholders. Their acts are subject to be tested by the familiar rules that govern the relations of a trustee to his cestui que trust."*** Subsequently, throughout a century, Delaware Courts have elaborated on the notion of fiduciary duties and their elements, as well as developed detailed standards for their applicability in various corporate settings.

While the essence of director's fiduciary duties can be defined as the duty to act in the best interest of the corporation, the concept is much more complex than this definition. In Cede & Co. v. Technicolor Inc. the Supreme Court of Delaware defined fiduciary duties as consisting of a triad of the following duties: a) loyalty b) due care and c) good faith. In later decisions the Supreme Court viewed good faith not a distinct element of fiduciary duties but rather as a subset of duty of loyalty. We shall now separately discuss each of these elements.

Duty of Loyalty

Duty of loyalty requires acting (including refraining from action) on a disinterested and independent basis, in good faith, with an honest belief that the action is in the best interests of the company and its stockholders.[4] From Delaware Supreme Court decisions we may infer the following non-exhaustive list of main components of duty of loyalty:

- Duty to act in good faith
- Prohibition of appropriating corporate opportunities rightfully belonging to the corporation
- Duty of fair disclosure
- Duty to prevent a take-over only where there is a threat to corporate policy
- Duty to make a reasonable effort to obtain the highest value for a company in a hostile takeover

[1] TRUST AND FIDUCIARY DUTY IN THE EARLY COMMON LAW by David J. Seipp p. 1014-1015
[2] Id. at p. 1016
[3] Id. at p. 1025
[4] https://corpgov.law.harvard.edu/2020/03/10/directors-fiduciary-duties-back-to-delaware-law-basics/#1

Good faith: A landmark Delaware court case that elaborates on the duty to act in good faith is In Re Walt Disney Co. Derivative Litigation. Interestingly the Supreme Court elaborates on the concept not by defining good faith but rather by presenting examples on what constitutes bad faith. Namely, the Court identifies at least the two following types of bad faith behavior:
"Subjective bad faith", where the fiduciary conduct is motivated by the actual intent to do harm, including preference of adverse self-interest or of a related person to the interest of the corporation;
"A conscious disregard of one's responsibilities", where the fiduciary intentionally fails to act in the face of a known duty to act.

The Court also clarifies that grossly negligent conduct on its own does not constitute a breach of the duty to act in good faith but rather in the context of fiduciary duties may only constitute a breach of due care.

Corporate opportunity doctrine: A sub-set of subjective bad faith is stealing a business opportunity presented to or otherwise rightfully belonging to the corporation. The Delaware case law on corporate opportunity is well established, it clarifies both when a director cannot take a business opportunity for his own and when they can do so. In particular, a director may not take a business opportunity for his own if "(1) the corporation is financially able to exploit the opportunity; (2) the opportunity is within the corporation's line of business; (3) the corporation has an interest or expectancy in the opportunity; and (4) by taking the opportunity for his own, the corporate fiduciary will thereby be placed in a position inimicable to his duties to the corporation.". To the contrary, the director may take a corporate opportunity if: "(1) the opportunity is presented to the director or officer in his individual and not his corporate capacity; (2) the opportunity is not essential to the corporation; (3) the corporation holds no interest or expectancy in the opportunity; and (4) the director or officer has not wrongfully employed the resources of the corporation in pursuing or exploiting the opportunity".[5]

Disclosure duties: In Re GGP, Inc. Stockholder litigation the Supreme Court of Delaware summarized that the fiduciary duty of disclosure is the application of corporate directors' fiduciary duties when directors seek stockholder action, such as approval of a proposed merger, asset sale, or charter amendment. Under these circumstances directors are bound by "a fiduciary duty to disclose fully and fairly all material information within the board's control". Information is considered material "if there is a substantial likelihood that a reasonable stockholder would consider it important in deciding how to vote".

Depending on circumstances the duty of disclosure may fall under the duty of loyalty or under the duty of care. The Court through citing previous cases distinguished them in the following manner:" a good faith erroneous judgement as to the proper scope or content of required disclosure implicated the duty of care rather than the duty of loyalty…however, where a complaint alleges or pleads facts sufficient to support the interference that the disclosure violation was made in bad faith, knowingly or intentionally, the alleged violation implicates the duty of loyalty..".

Takeover defence implementation: The famous Unocal Corp. v. Mesa Petroleum Co. deals with fiduciary duties of directors when implementing defences to corporate takeovers. Under such circumstances directors' conduct shall comply with the following two requirements:

a) A defensive measure to prevent a takeover shall be motivated by a good faith concern for the welfare of the corporation and its stockholders and in all circumstances must be free of any

[5] Broz v. Cellular Info. Systems, Inc.,

fraud or other misconduct. This requirement mandates directors to refrain from acting solely or primarily out of the desire to prolonging their tenure in office.
b) The defensive measure shall be reasonable in relation to the threat posed.

Duty to secure the best price: The logical continuation of Unocal Corp. is Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., where the Delaware Supreme Court deals with fiduciary duties of directors where the sale or break up of the company is inevitable. In this situation the duty of directors shift from preserving the company as a corporate entity to securing the best sale value of the company to the benefit of the shareholders. As the Court puts it: "The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."

Duty of Care
Duty of care can be broken down into the following non-exhaustive components:

- duty to be informed
- duty of oversight
- duty to act in a timely manner to address any potential problems

The first component of duty of care requires directors to be informed of all material information reasonably available to them before making a business decision. In Smith v. Van Gorkom, where the Delaware Supreme Court dealt with an approval of a merger, it held that a director's duty to to exercise an informed business judgment is in the nature of a duty of care, as distinguished from a duty of loyalty. It also held that gross negligence is the proper standard for determining whether a business judgement reached by the directors was an informed one.

In the context of a merger transaction directors have a duty to act in an informed and deliberate manner in determining whether to approve an agreement of merger before submitting the proposal to the shareholders. Directors may not abandon that duty by leaving it up to the shareholders alone to decide on the agreement.

In In re Caremark International Inc., the Delaware Court of Chancery set the standard of duty of care in the context of director oversight. According to the Court, "only a sustained or systematic failure of the board to exercise oversight such as an utter failure to attempt to assure a reasonable information and reporting system exits will establish the lack of good faith that is a necessary condition to liability. Such a test of liability lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight is quite high." The Court also named the rationale behind the high bar of the test which is the likeliness of willing to serve on board by qualified persons. In other words, it is less likely that qualified persons would be willing to serve as directors if they know that they are facing a high risk of being held liable for oversight failure.

Business Judgement Rule

Summary of fiduciary duties cannot be complete without making reference to the business judgement rule (BJR). BJR is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. The party challenging the decision bears the burden of proving the opposite.[6] In Sinclair Oil Corporation v. Levien the Supreme Court of Delaware ***"a board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose".*** The rationale of the business judgement rule can be summarized as follows: a) No business can be properly conducted without taking risks, penalizing directors merely for taking a wrong

[6] Aronson v. Lewis

business decision may prevent directors from taking risks which in turn will harm the business; b) Judges are not in the best position to assess whether a particular business decision was right or wrong.

Overview of Fiduciary duties under the laws of Russian Federation

Compared to those under Delaware, fiduciary standards of conduct under the laws of Russian Federation are stricter. Delaware Courts give strong deference to business judgement of directors, if they were made in good faith and due care – even if they were not "very wise", whereas Russian Courts will go further to assess the reasonableness of the transaction approved by the decision. To better demonstrate this difference we shall briefly go over the main rules concerning fiduciary duties in Russia.

Fiduciary duties under the laws of Russian Federation are embedded in Article 71 of the Law on "Joint-Stock Companies". First part of the said article provides a general definition on the scope of fiduciary duties for members of the board of directors, as well as executive officers and the remaining parts provide the rules on liability for breaching those duties. To begin with the general definition, members of the board of directors and executive managers shall act in the interest of the company, shall exercise their rights and carry out their duties in relation to the company in good faith and in a reasonable manner. The Civil Code also contains a provision that establishes rules similar to those described above for board directors and executive officers of all types of legal entities.

Standards on what conduct is considered to be "in good faith" and "reasonable" has been developed by the judiciary, namely by the High Arbitration Court of the Russian Federation in its decision on certain matters related to providing compensations by persons included in the governing bodies of a legal entity. Interestingly, instead of defining what is considered as good faith or reasonable, the Court proceeded with outlining types of conduct that fall on the spectrum of bad faith or unreasonableness. Conduct in bad faith is considered to be established when the director (executive officer):

1) was acting based on a conflict of interest, except in cases where that conflict of interest has been disclosed in due time and the actions of the director (manager) have been approved in accordance with law;
2) has been hiding information on a transaction performed by them from the participants of the legal entity or has provided misleading information in connection with the relevant transaction;
3) has executed the transaction without the required approval of the competent bodies of the legal entity;
4) following termination of office is refraining from providing the legal entity with documents that concern circumstances that have brought unfavorable consequences for the legal entity;
5) knew or should have known that their actions (inactions) at the time of their occurrence were not in line with the interests of the legal entity, for example executing a transaction on conditions obviously unfavorable to the legal entity or with a counterpart not being able to perform its obligations.

The said decision also clarifies when the transaction is considered to be on unfavorable terms, namely when the price and other conditions of the transaction are materially worse in relation to the legal entity as compared to similar transactions entered into under comparable circumstances. As a general rule, the unfavorableness of the transaction is determined at the moment of its execution, although certain exceptions apply.

Turning to the element of reasonableness of fiduciary duties. Unreasonableness of a conduct is considered to be established when the director (executive officer):

1) has made a decision without taking into consideration information known to them that was related to the given situation;
2) before making the decision has not taken any steps aimed at receiving information necessary and sufficient for making the decision, that are customary in business practice in similar circumstances, in particular if it has been proven that under the given circumstances a reasonable director would postpone the decision until the receipt of supplemental information;
3) has made a transaction without following internal procedures required or customary in the given legal entity for entering into comparable transactions (e. g. seeking approval from the legal department, accounting etc.).

It is also worth highlighting that the decision has a statement similar to the business judgement rule. The statement is read as follows: "…negative consequences that took place for the legal entity at a time when the director was part of the governing bodies of the legal entity do not on their own constitute evidence on the bad faith or unreasonableness of his actions (inactions), because the possibility that such consequences will arise is in line with the risk prone nature of a business activity. Since the aim of judicial control is to ensure the defense of rights of legal entities and their founders (participants) and not to check the economic reasonableness of the decisions made by directors, a director may not be held liable for damages caused to the legal entity if his actions (or inactions) that caused the damages were simply part of a business risk."

At first, the citation above sounds close to the business judgement rule as the essence of both is the same: as a general rule, judges will not second guess business decisions taken by directors if they were taken in good faith and with due care. At the same time it is difficult to reconcile this statement on fiduciary duties with the standard of the unfavourableness of the transaction. On one hand the statement says that judges should not check the economic reasonableness of the decisions, on the other hand assessing the favourableness of the transaction requires analysis of its price and other conditions which essentially is checking the economic reasonableness of the transaction.

In fact, there are examples of judicial cases where the court has taken the economic unreasonableness of a transaction as a ground for establishing a breach of fiduciary duties. For example the Appellate Arbitration Court in one of its cases held the chairman of the Board of a bank and certain managers liable for breach of fiduciary duties for approving credits to certain persons that were not repaid to the bank. The liability was not based on conflict of interest but rather on the fact that the creditors had presented fake salary certifications from employers and the participants of the credit approval company failed to cross-check the salary certifications with other evidence.[7]

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Having completed the overviews, we shall now proceed to the last part of our article and highlight the advantages of each system of fiduciary rules and conclude with a short statement on what may be the underlying cause behind the differences in the systems.

First and a very well-known advantage of the Delaware system is its adaptation to a foundational axiom in the business world: risk is a natural and inseparable element of profit generating affairs. Avoiding risks, often means avoiding opportunities. Or as one of the greatest entrepreneurs of our times has put it: "In a world that is changing really quickly, the only

[7] See Case N A66-5162/2011, decided by 14th Arbitration Appellate Court

strategy that is guaranteed to fail is not taking risks."[8] If lawmakers promote policies and judges act as watchdogs scrutinizing every business decision adopted by directors, strong incentives will be created for directors to decrease risk taking out of the concern of being personally held liable in the future should the risks materialize and harm the corporation. In their turn, risk averse approaches in there extremes are a dangerous recipe leading to halt in profits, development and innovation.

Second obvious advantage is ensuring that being a corporate director remains an attractive jobs and draws talents. Delaware set of fiduciary rules essentially says that directors can rest assured that they will not be held liable for taking a business decision (even a seemingly unwise one) if they were acting in good faith and with due care (e. g. taking steps to gather the required information for making the decision). The opposite would discourage qualified professionals from serving on board and would make retaining a board more expensive as hardly anyone would be willing to face an increased risk of personal liability in unpredictable sums and under unpredictable circumstances. One other consequence of strict scrutiny of business decisions in the absence of bad faith, conflict of interest or lack of care in this context would be placing public companies at a disadvantage as compared to privates. Closely-held companies, where the number of shareholders is limited, generally the degree of trust between shareholders, directors and executives is higher. This makes one more comfortable with holding a directorship (or an executive position) in a private company rather than holding a position in a public corporation and being sued by corporate activist Carl Icahn for every faulty decision you make.

Last but not least, no proper tools exist to assess the correctness of a business decision. Most often than not, business decisions are made under uncertainties and only future demonstrates the "righteousness" of business decision. But even then, one cannot be sure whether no better alternative decisions could be taken. In addition, judges are not trained in evaluating business decisions and as implied manifold by Delaware courts: running the business is job of the business people and not the judges'.

Turning to the benefits of the stricter model of fiduciary duties under the Russian law. The first potential benefit worth mentioning is decrease of moral hazard. In its simplest form moral hazard can be defined as a situation, where a person is motivated to take additional risks because they will not incur the full losses related to those risks. Lenient fiduciary duties with strong deference to business judgement of directors makes risk taking more comfortable. While not taking any risks is the biggest risk in business, the opposite end of the spectrum with excessive risk taking is not beneficial for the business either.

Second benefit is that stricter penalties of poor management will make unprepared candidates think twice before consenting to directorships. If a rational person knows that poor decision making will make them personally liable and also knows that they do not have the requisite skills for overseeing or managing a particular company, chances are they will refuse an offer presented to them.

Russian system might be more suitable for catching and penalizing director recklessness. If under Delaware law, directors establish best practice procedures of oversight and reporting, yet take unjustified risks, in the absence of conflict of interest, it would be difficult to hold them liable. In order for them to be liable, most often the mere "absurdity" of a business decision is not sufficient, bad faith (i. e. intentional recklessness) shall be established. In practice establishing facts that differentiate intentional recklessness from ordinary business risk taking is not always possible. Whereas the Russian system of fiduciary duty rules allows the

[8] Quote by Mark Zuckerberg

assessment of the favorableness of a transaction without an additional subjective element as a basis for holding corporate leaders liable.

Reaching to our final point in this article, we shall share some thoughts on what may be the reasons that account for the differences between the systems of fiduciary duty rules we have discussed. In our assessment, the main reason lies in the bigger role that public companies play in the economy of US compared to Russia. It takes an extra mile to convince a person to serve on a board of a public company due to the multitude and unfamiliarity of all stakeholders involved. Business judgement rule has the function of providing such comfort by protecting them from frivolous suits. The second possible reason we would like to highlight, which in fact is closely related to the first reason, is the difference in the degree of protection of minority shareholders in the two countries. If we trust the archive of Doing Business reports[9], the degree of protection of minority shareholders is considerably higher in US, which also means that in the US directors are facing more pressure in ensuring that minority shareholders are satisfied and face higher risks of being sued if they are not. Thus, they require more protections from petty lawsuits.

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[9] Doing Business project was discontinued on September 16 2021 and the reasons behind the discontinuation question the reliability of the Doing Business reports