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Law Working Paper N° 001/2002
October 2002

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This paper can be downloaded without charge from:
https://doi.org/10.67929/ecgi-law-001-2002

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ECGI Working Paper Series in Law

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*We are indebted to Dimitri Gavriline, Moscow (Russia), and Professor Stanislaw Soltysinski, Warsaw (Poland) for locating relevant case law. We would also like to thank participants at the authors' workshop and the conference on "Global Markets, Domestic Institutions: Corporate Law and Governance in a New Era of Cross-Border Deals" held at Columbia Law School in October 2001 and April 2002 respectively. Special thanks to our commentator at the conference, Reinier Kraakman, and to the participants at the seminar on Politics, Law and Development and NYU Law School, in particular to the chair of that seminar, Lewis Kornhauser. All remaining errors are those of the authors.

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Abstract

In Anglo-American law, fiduciary duty is the core legal concept to address conflicts among directors/managers and shareholders. The concept is developed and constantly refined by courts in the process of adjudication. By contrast, most civil law jurisdictions, including many transition economies, either lack the procedural rules that would enable parties to bring such cases to courts, or have not developed a sufficient body of case law to determine the contents and meaning of this concept. This paper asks, whether courts should be allocated the right to define and enforce fiduciary duty principles. Based on our theory of the incompleteness of law, this paper argues that when law is highly incomplete, but the expected harm can be contained and does not cause externalities, allocating lawmaking and law enforcement to courts is optimal. Breaching fiduciary duty is such an area, as harm is typically limited to shareholders of a given company. While courts in transition economies may have difficulties living up to the task of exercising lawmaking rights in this area, we propose that there are few alternatives and that encouraging an active learning process should therefore be encouraged. We investigate emerging case law on the duty of loyalty in Poland and Russia and draw some comparisons to German case law.

Keywords: incomplete law, transition economies, fiduciary duty, law enforcement

JEL Classifications: K10, K23, K40, K42, P3

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Fiduciary Duty in Transitional Civil Law Jurisdictions
Lessons from the Incomplete Law Theory

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Introduction

Fiduciary duty is a core concept in Anglo-American corporate law for delineating the rights and responsibilities of directors and managers, as well as dominant shareholders vis-à-vis minority shareholders. Yet its precise meaning is difficult to discern without reference to a large body of case law. Judge-made law has over time carved out a subset of specific obligations and standards of conduct derived from this principle. Most widely accepted are the duty of care and the duty of loyalty, where the duty of loyalty refers to situations in which conflict of interest is present. The meaning of each of these obligations is explained by referring to a subset of more specific obligations. Some of these obligations have been codified.[1] This is true in the US, for example, for the duty to disclose material information to investors and shareholders. Those that have not, or where codification still left sufficient room for

[1] The Securities and Exchange Act includes numerous provisions that could be regarded as a specification of directors' duties vis-à-vis their investors. Similarly, state takeover rules specify the standards of behavior of directors in a takeover situation. Yet, most of these provisions remain rather ambiguous and require further specification by courts.

ambiguity as to the scope and meaning of the law, are derived by courts in the process of adjudication.

Thus, in Anglo-Saxon countries, courts are in charge of determining the boundaries of managers' obligations to shareholders – boundaries, which are inherently difficult to circumscribe exhaustively. As Clark puts it, "this general duty of loyalty is a residual concept that can include factual situations that no one has foreseen and categorized" (Clark 1986:141). The broad and encompassing nature of Fiduciary Duties appears to be a crucial factor in explaining the importance it has acquired in Anglo-American jurisdictions (Clark 1986; Coffee 1989; Eisenberg 2000; Johnson et al. 2000). It has allowed courts to take account of the changing nature of the business enterprise while maintaining at least the semblance of undisputed principles for determining what is right and what is wrong in corporate conduct.

As many have pointed out, the corporate law in the U.S., especially in Delaware, has developed from a (fairly) prohibitive, or mandatory law into an enabling corporate law, which allows shareholders to opt out of many legal provisions and substitute their own contractually determined arrangements (Coffee 1989); (Black and Kraakman 1996). Nevertheless, shareholders (or rather those controlling the process of charter and by-law making) have not been able to opt out of the principle of fiduciary duty, which has gained in importance as the law has become more enabling (Coffee 1989). The contrast with corporate law in many civil law jurisdictions is stark. German law, for example, explicitly states that all provisions of the corporate law are mandatory, except where otherwise stated,[2] and courts have not played an

[2] Compare Sec. 23 of the German Law on Joint Stock Companies (AktG).

important role in determining the rights and wrongs of corporate conduct, at least not for publicly held corporations.[3]

The same qualities that make the concept of fiduciary duties so resilient over time make it extremely difficult to transplant to other legal systems. The meaning of fiduciary duty cannot easily be specified in a detailed legal document. Attempts to do so will either leave out many actions or factual situations "no one has foreseen or categorized" (Clark 1986), or will be phrased so broadly that the meaning can be understood only in the context of specific cases. Thus, transplants of substantive rules can at best be partial. In this paper, we investigate alternative strategies for countries wishing to develop the institutional framework for effective enforcement of fiduciary duties. A major proposition is that it might be advisable to shift attention from *substantive* to *structural* transplants, or put differently, to focus more on the allocation of lawmaking and law enforcement powers (LMLEP) than on the contents of specific legal rules.

The process of legal reform in transition economies to date has entailed primarily the transplantation of statutory law from Western European or U.S. legal sources (Pistor 2000). These transplants have focused on the contents of legal rules and principles of corporate law known in the West – that is, on *substantive* transplants. Even when U.S. law was taken as a model, the role of courts was kept at bay, as they were regarded as weak, incompetent or even corrupt (Black and Kraakman 1996). In this paper, we ask whether a superior mode of transplantation might be a *structural transplant*, defined as the imitation not of substantive rules, but of the allocation of LMLEP. We address this question drawing on our earlier work on the incompleteness of law (Pistor and Xu 2002a; Pistor and Xu 2002b). The thrust of our argument is that

[3] As we will discuss below, this is different in limited liability companies (GmbH), where courts have

every legal system must allocate the right to deal with future contingencies that were unforeseen when the law was announced. The reason is that law is intrinsically incomplete, meaning that it is impossible to design a law that would specify all future contingencies, and thus could act as an effective deterrent device.[4] When law is incomplete, the effectiveness of law and law enforcement is contingent on how a legal system deals with the right to determine the content and meaning of law when future contingencies arise – how it allocates LMLEP to deal with future scenarios. A legal system may allocate these powers to courts or to regulators, or a combination of the two. It may also decide that private parties should resolve these issues by denying (easy) access to the formal legal system. In our other work, we identify three factors that determine the optimal allocation of LMLEP: the degree of incompleteness of the law, the ability to standardize actions that may result in harm ex ante, and the level of expected harm (Pistor and Xu 2002a; Pistor and Xu 2002b). Applying this framework to the problem of fiduciary duty, we argue that courts are the optimal holders of LMLEP for this area of the law. Law is highly incomplete, but actions cannot be easily standardized, thus making it infeasible to allocate LMLEP to regulators. Moreover, because the level of expected harm is relatively contained, reactive law enforcement is sufficient for remedying harmful actions.

The effectiveness of the courts' residual lawmaking powers depends on the willingness of victims to bring cases to court, which in turn depends on the actual or perceived quality of the courts. If courts are weak, they may not be effective residual lawmakers and law enforcers, even if they are vested with extensive residual lawmaking powers. Courts in transition economies are widely perceived to be weak,

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played a much more active role. We suggest that this is related to procedural rules that make it easier for shareholders in closed corporations to bring judicial action than in publicly held ones.

inexperienced, or even corrupt (Black and Kraakman 1996; Glaeser et al. 2001), although a number of empirical studies paint a somewhat different picture (Hendley 2001; Hendley et al. 1997). Vesting courts with LMLEP will therefore require extensive institutional reform in many transition economies. Governments wishing to credibly commit to a structural transplant would need not only to change statutory law in order to explicitly allocate lawmaking powers to courts. They would also need to strengthen courts as independent institutions and ensure that they have sufficient resources to fulfill this task. Even this may not be sufficient, as ultimately it will depend on the courts to use the opportunity the law gives to them to engage in lawmaking activities. Our main point is that while this is a difficult task and will take time to accomplish, it cannot be easily circumvented by writing law that limits the role of courts in this crucial area of the law.

In the second part of the essay, we analyze the statutory and case law in three jurisdictions (Poland, Russia, and Germany) on matters that would fall within the scope of fiduciary duty in Anglo-Saxon countries. The focus of our analysis is the allocation of LMLEP in these jurisdictions and how courts have made use of their empowerments. A hallmark of all three jurisdictions is that case law is scarce, even in Germany, a highly developed market economy with extensive experience with corporations and corporate law. We suggest that case law evolved in these jurisdictions whenever procedural rules gave access to judicial review and substantive rules were sufficiently specified to serve as guidance. Analyzing available case law, we argue that even in civil law countries or countries with a socialist legal past, it is not impossible to vest courts with more expansive LMLEP. Yet, in light of their legal heritage it might be advisable to specify some typical applications of legal principles

[4] We recognize that lawmakers have some discretion to determine the relative completeness of law as

in statutory law as guidance for potential litigants and judges alike. At the same time, the law should be clear that judicial review will not be limited to these typified cases.

I: Incompleteness of Law and the Allocation of LMLEP

In this part of the essay we explain the core elements of the incomplete law theory we use as a framework to determine the optimal allocation of LMLEP for handling cases related to the proper governance of corporations.[5]

A. Incompleteness of Law

If law were complete – if a law could stipulate unambiguously all future contingencies, it could fully deter harmful actions, including actions that may result in the violation of fiduciary duties. The key task for such a law would be to stipulate the appropriate level of punishment and to ensure that the probability of detection is sufficiently high. Indeed, much of the traditional literature on law enforcement (Becker 1968; Polinsky and Shavell 2000; Stigler 1964) focuses on these variables and treats law implicitly as complete. By contrast, if law is incomplete, law cannot effectively deter. In this second best world, legal systems need to allocate LMLEP to deal with future contingencies that were unanticipated at the time law was made, in order to enhance (not to perfect) the effectiveness of law enforcement. Absent the allocation of LMLEP, many actions will not be sanctioned, even if they result in substantial harm. Legislative change may make law more complete after assembling

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suggested in the rules vs. standards literature. See Kaplow (1992) and Kaplow (1995). However, even the most ambitious lawmaker would not be able to write a fully complete law.

sufficient experience, but this will have only prospective effect. Moreover, new actions or factual situations the revised law did not contemplate will undoubtedly arise, leaving it once more incomplete.

A similar argument has been made in the economics literature with regards to contracts: parties to a contract cannot foresee all future contingencies and therefore cannot write a complete contract (Hart 1995). However, parties can renegotiate the contract in the future once new uncertainties have been resolved and thus make the contract highly complete. Law can be regarded as a grand social contract in that it attempts to offer legal guidance for outcomes to future generations of citizens. In countries governed by the rule of law, law is purposefully designed to address a large number of cases and to last for long periods of time. The use of abstract language in statutory law is a means to ensure its generality. Even case law is made not only for the specific case at hand; the court's ruling applies equally to other cases with a similar (not necessarily identical) factual basis (Ginsburg 1996). If contractual parties cannot write complete contracts, lawmakers should be even less able to write complete statutory law. In fact, to write a complete law, lawmakers would need not only unlimited foresight, but should be blessed with unbounded rationality. They would need to be able to anticipate the impact of the rules they make on all potential parties concerned and write rules that can achieve the first – best results from a social welfare perspective.

An important reason why it is difficult to write even fairly complete law is that the meaning and scope of law is continuously challenged by socioeconomic and technological change. In a static world, law can achieve high levels of completeness. Take, for example, the development of criminal and tort law until the mid 19th

[5] In this essay we focus on publicly held corporations. However, similar conflicts arise in close

century. Statutory and case law by that time had well specified the meaning of theft of assets and the conditions for holding someone liable for deceit. Increasingly, however, objects such as electricity, ideas, and telephone lines became subject of appropriation that differed from cases for which the law had been designed. Similarly, the legal principles governing fraud and deceit were developed for cases where asymmetry between the parties was limited and the truth of the matter was easy to verify. With the growth of markets for financial instruments, the asymmetry of information between seller and buyer increased, as did the value of information. Someone with the power to change and adapt law had to decide whether existing legal principles that had been developed with different cases in mind should be used to resolve these cases, or whether different principles were needed, and if so, stipulate such principles.

Given the incompleteness of law, a crucial question is who should hold the power to interpret or make new law in the future and to resolve questions about the application of existing law to new cases. Unlike contracts, where the parties to the original contract or their assignees have the power to renegotiate, for law the question who holds residual lawmaking power is less obvious. Thus, legal systems must allocate these rights. In doing so, legal systems must address two questions: who should hold these rights in order to ensure effective law enforcement, and what factors should be considered in allocating these rights to different agents.

The notion that law is ambiguous or indeterminate – concepts that are close to our term "incompleteness" – has long been recognized in the legal literature (Hart 1961; Solum 1999). In addition, a substantial literature has analyzed the optimal choice between standards and rules (Kaplow 1992; Kaplow 1995; Kaplow 1997). Thus, the

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corporations. In fact, some jurisdictions, including Delaware, do not distinguish among these two type

claim that law is incomplete is not a novelty to most lawyers. What our theory seeks to add is that incompleteness of law is not merely a matter of choice, but at a fundamental level law is intrinsically incomplete, that is, lawmakers *cannot* write a complete law. To enhance the efficacy of law, legal systems must therefore allocate LMLEP. The key contribution of the incompleteness of law theory is its emphasis on properly designing enforcement institutions as a response to incompleteness of law.

The concept of fiduciary duty discussed in this paper is an example of a highly incomplete law. This broad principle encompasses all actions that might violate the rights of principals by fiduciaries. To avoid imposing the risk of excessive law enforcement on fiduciaries, however, the law must be able to exclude actions from its applicability that do not warrant liability, and must be able to do so with sufficient certainty ex ante. Specific applications of fiduciary duty can, and indeed have been, carved out and codified. Examples include the duty to disclose information to shareholders and to notify them in advance of shareholder meetings, and conflict of interest provisions in corporate statutes that specify circumstances when directors may not act on their own, but must seek shareholders approval or abstain from voting. Indeed, closer inspection might reveal that there are more cases where codification might be possible and desirable. Where rules can be sufficiently specified, codification can safe costs for individual actors, as well as law enforcers. The codified parts of fiduciary duty would not form part of the residual anymore. Yet, they would still share the same value judgment and should carry comparable sanctions.

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of companies when it comes to the application of fiduciary duty principles.

B. The Allocation of Residual Lawmaking and Law Enforcement Powers (LMLEP)

Once the notion that law is intrinsically incomplete is accepted, the question arises who should hold residual lawmaking and law enforcement powers. We argue that this should be determined by the lawmaking and law enforcement functions different agents perform. Legislatures are agents that make law ex ante, but typically do not exercise any law enforcement powers. Courts usually make law ex post, that is, after the critical facts of a case have been revealed. However, once made case law also has ex ante implications for actions taken in the future. In addition, courts exercise law enforcement powers. An important feature of courts is that they enforce law only after some other party brings an action. This party may be the victim, or it may be a state agent, such as a prosecutor or administrative agency. The reason that courts do not act on their own initiative follows from the rule of law notion that courts should act as neutral arbiters.

Similar to courts but unlike legislatures, regulators combine lawmaking and law enforcement functions. Like legislatures, they make law ex ante. Regulators however, are typically vested only with limited lawmaking powers defined by certain activities or sectors, yet within the scope of their lawmaking powers, they can change the law more flexibly and with fewer procedural requirements. This allows them to be more responsive to socioeconomic or technological change than legislatures. However, a similar function could be achieved by setting up a special parliamentary committee to deal with a specialized area of the law. The distinctive feature of regulators thus lies not in greater flexibility and greater expertise than legislatures, but in combining lawmaking and a particular type of law enforcement power that is

different from the courts' law enforcement powers. What distinguishes regulators from courts is that they can enforce law proactively. In contrast to courts, regulators can launch an investigation, enjoin actions, or impose fines on their won initiative. These particular features make regulators potentially very powerful law enforcers. These very same features raise concerns, as regulators may use these powers excessively and thus suppress potentially beneficial actions or engage in rent-seeking activities.[6] To optimize law enforcement it is therefore important to identify the conditions under which the benefits of LMLEP allocation to regulators outweighs its potential costs.

C. Allocating LMLEP for Resolving Fiduciary Duty Cases

According to our theory, the choice between regulators and courts depends on the degree of incompleteness of law, the possibility of standardizing, at reasonable cost, actions that may result in harm, and the degree of harm that may result from harmful actions (Pistor and Xu 2002a; Pistor and Xu 2002b).

When law is highly complete, the law can determine appropriate sanctions ex ante, and reactive enforcement by courts is sufficient to enforce the law effectively. When law is highly incomplete, the optimal allocation of LMLEP is determined by the degree of expected harm and the costs of standardizing actions that might result in harm.

An example where high levels of expected harm are matched with reasonable costs of standardizing actions are disclosure requirements for firms issuing shares to the public, or safety standards imposed on producers of pharmaceuticals, automobiles,

[6] This is the classic objective raised against regulators. See Stigler (1964); Stigler (1971); and Posner

or aircraft. Disclosure rules capture only one particular aspect of the relation between firms (and their agents) and investors. This is, however, an area where past experience suggests that lack of disclosure may result in substantial harm not only to current shareholders or future investors in a particular firm, but also to investors more broadly and ultimately the functioning of the financial market as a public good. When firms come to the market, investors face a lemons problem (Akerlof 1970). Incidences of misrepresentation of information may seriously discourage investments in shares, as is evidenced by market crashes in response to the revelation of stock fraud schemes (Milgrom and Stokey 1982). Thus, the expected degree of harm is high. Fortunately, however, disclosure rules can be standardized at reasonable cost. Lawmakers can define the type of information that must be disclosed, and adapt these rules over time as market behavior changes or as it becomes apparent that investors require different information.[7] They can also use this information to determine whether further action is needed, such as the initiation of proactive enforcement activities in the form of investigations.

By contrast, when individual actions are not expected to generate much harm, or if standardization of such actions entails high costs, allocating lawmaking and law enforcement powers to the courts is superior even when law is highly incomplete. Law enforcement related to fiduciary duties is an example where the level of incompleteness is high, standardization is possible only for some areas – leaving a large undefined residual – and the expected harm is relatively contained. Fiduciary duties govern the relationship among stakeholders in a particular undertaking (management vs. shareholders, block holders vs. minority shareholders). The harm done when these duties are violated is typically confined to a subset of these same

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(1974).

shareholders. While investors may be wary of investing in that particular firm in the future, their confidence in investing in shares in general will be shaken only when fiduciary duty violations are systemic. Reactive law enforcement can compensate those shareholders that have actually incurred damages. In fact, empirical studies suggest that law suits brought in response to alleged violations of fiduciary duty have not had a significant impact on share value of the company involved, much less on other companies' shares (Romano 1991). Law enforcement by regulators may not only be unnecessary, but even harmful, because it is extremely difficult to stipulate ex ante the type of actions that may result in harm. Allowing regulators to proactively enforce the law in these cases would likely result in excessive intervention in the operation of private businesses. Thus, the direct cost of regulating all possible actions that might result in violations of fiduciary duty principles would be excessive. Moreover, such regulation would likely err in discouraging or preventing actions that could be economically beneficial. In these cases allocating residual lawmaking powers to regulators does not appear to be a viable solution. Instead, vesting courts with ex post LM and reactive LE powers is superior.

Since is impossible to write a fairly complete law that would comprehensively deal with actions that may be considered violations of fiduciary duty principles, failure to allocate LMLEP to courts implies that these actions cannot be resolved within the formal legal system. One may argue that this is desirable, as the stakeholders' concerned best deal with these matters informally and litigation may only disrupt, rather than improve relations among these stakeholders. Indeed, German law has quite consciously limited the justiciability of corporate affairs precisely for these reasons, and any attempt to extend the right of shareholders to bring litigation

[7] Of course, one may dispute whether changes in disclosure rules in fact respond to investor interests.

confronts the argument that this is better left to negotiations at the company level.[8] However, empirical evidence suggests that this strategy might not be conducive to capital market development. Available empirical studies have shown that among countries with developed financial markets, those with better minority shareholder protection, including "anti-directors' rights" that allow shareholders to take management to court, have less concentrated ownership and more developed capital markets than countries that do not offer similar protections (La Porta et al. 1997; La Porta et al. 1998). While the relevance of the individual legal indicators used to assess the quality of minority shareholder protection in these studies may be subject to dispute (Pistor 2001), an important structural feature that distinguishes countries with better shareholder protection is that they tend to vest shareholders with litigation rights against directors and management. In other words, they provide a framework for solving these disputes within the formal legal system. This seems particularly important for transition economies, where the extensive process of reallocating property rights in firms is recent the contents of shareholder rights is still uncertain, and minority shareholders have been systematically disenfranchised by company insiders (Black et al. 2000; Frydman et al. 1996; Pistor 1998).

The importance of adjudication of shareholder rights as a means of controlling management also seems consistent with the "Delaware puzzle." The puzzle is that companies incorporated in Delaware have higher market value than companies incorporated elsewhere in the U.S. (Daines 2001), despite the fact that the Delaware statutory law is rather weak in protecting shareholder rights (Arsht 1976; Cary 1974; Larcom 1937). In fact, Delaware statutory law is not a stellar performer on the scale

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For a critical assessment of disclosure rules in the U.S., see e.g. Benston (1976).

[8] For a discussion of German law, see below, Part II.

of shareholder rights identified by La Porta et al.[9] Several authors have suggested that the solution for this puzzle lies in the function of the Delaware courts (Fisch 2000; Coffee 1989; Daines 2001). This is consistent with our theory. The fact that Delaware courts exercise LMLEP and that – perhaps because of the enabling nature of the corporate law – they were increasingly called upon to resolve disputes, resulted in courts developing a large volume of case law. In doing so they have specified the meaning of the principle of fiduciary duty over time, or made the principle more complete. Given the higher level of completeness of the case law (not the statutory law, shareholders are better protected in Delaware than in other states that do no have an equally comprehensive body of law.

To summarize, our basic argument is that the principle of fiduciary is a highly incomplete legal principle. To ensure effective law enforcement, residual lawmaking and law enforcement powers must be allocated. Since the actions that may violate fiduciary duty principles do not lend themselves well to standardization, and the expected harm affects primarily the company's shareholders, not investors or society more broadly, residual lawmaking and reactive law enforcement by courts is optimal.

II: Case Law From Civil Law Jurisdictions

In this part, we analyze relevant case law using the theory summarized in the previous section. We focus on cases which, in the Anglo-Saxon context, would be analyzed under the rubric of fiduciary duty. The goal of this analysis is to identify the allocation of LMLEP in these jurisdictions and to assess how that allocation has

[9] The one-share-one-vote rule is only optional, shares *can* be blocked before the meeting; cumulative voting is only optional; preemptive rights require explicit recognition in the corporate charter. Delaware does, however, offer proxy by mail, the right of 10% shareholders to call an extraordinary

affected the ability of these jurisdictions to resolve conflicts between managers and shareholders. Our analysis reveals that the allocation of LMLEP, as reflected in substantive and procedural law in all three jurisdictions, is sub-optimal. Russia seems closer than the other jurisdictions to allocating LMLEP to courts, but has limited this allocation to only a subset of rules. Poland's very broad substantive principle of fiduciary duty has not given rise to much litigation, and in Germany procedural rules have limited the scope of judicial lawmaking with respect to the duties management owes to shareholders.

An important caveat to these conclusions is that in transition economies case law is only emerging. In fact, in many countries not a single case concerning the violation of fiduciary duty has been reported in the higher courts.[10] It is therefore difficult to predict whether the few cases we have reviewed are indicative of future trends. But at least they allow us to take a glance at the evolving law.

The only non-transition country included in this study is Germany. German law has long influenced the development of statutory civil and commercial law in Central and Eastern Europe (Pistor 2000). It is therefore reasonable to assume that German case law may also gain influence in countries that borrowed German statutory law. In this sense, the analysis of German case law on fiduciary duty may hold important clues for the evolving case law in transition economies. But there is another, potentially more important, reason for including German case law in this analysis. German corporate law has consciously limited the scope of LMLEP for conflicts between managers and shareholders, but has allowed litigation for conflicts among

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shareholder meeting, and – in our view most importantly – the right of shareholders to sue management.

[10] Unfortunately, given lack of access to the relevant cases, we could not extend the analysis to cases resolved at the trial courts (courts of first instance).

shareholders. Thus, Germany offers a good opportunity to analyze the impact of alternative procedural rules on litigation outcomes.

A. Poland

Poland recently enacted a new Companies Act.[11] Currently available case law however, is based on the Commercial Code (CC), which was originally enacted in 1933 and formed the basis of the evolving post-socialist corporate law. The analysis that follows thus relates to the CC. The code included almost identical provisions on the liability of managers and directors in close and publicly traded corporation. Article 474 CC on publicly traded corporations read:

> 1. A member of the company's governing bodies and the liquidator are liable to the company for damage caused by their actions which are contrary to the law or the provisions in the Company Statute.
> 2. A member of the company's governing bodies and the liquidator are liable to the company for any damage caused as a result of their failure to exercise the care of a diligent trader.

The key issue in this provision is what is meant by "diligent trader," a highly incomplete legal term. No further specifications can be found in the law, leaving it to holders of LMLEP to decide this issue. Absent reference to regulators, this issue could be decided informally by the parties concerned or by the courts, provided, of course, that procedural rules exist to ensure that management can be sued for violating its duties of a "diligent trader." Section 474 explicitly states that directors are liable to the corporation, not to shareholders directly. In principle, the corporation and not its shareholders shall take action against members of the governing bodies. The CC did, however, allow shareholders to bring an action on behalf of the corporation, if the

corporation had itself failed to act for more than a year after having discovered the facts giving rise to liability claims (Sec. 477 CC). Given these procedural constraints and the highly incomplete principle embodied in statutory law, it is perhaps not surprising that case law is scarce. In fact, for publicly traded corporations, there has not been a single ruling by the Polish Supreme Court. We therefore report a 1998 decision of the Katowice Court of Appeal.[12] The decision deals with the duty of care of members of the board of directors. No claim of conflict of interests was made in the case.

The plaintiff was a shareholder of the Bank Ślaski SA (the Bank). Defendants were members of the board of directors (management board) of the Bank.[13] The bank was privatized in 1994 and a special unit inside the Bank, a brokerage house with substantial organizational and financial independence, was charged with organizing the issuance of shares. The task of supervising the activities of the brokerage house was delegated to one member of the board. When shares were offered in the privatization process, they were heavily over-subscribed, and Bank was unprepared to deal with the situation. In particular, the Bank had failed to set up appropriate internal procedures to ensure that the rules and regulations on privatizing the bank were fully complied with. This failure constituted a violation of securities regulations of which the Polish Securities and Exchange Commission (KPWiG) fined the Bank. Moreover, the member of the board that had been in charge of supervising the issuance of shares was fired. In the case brought before the court, the plaintiff demanded that other members of the board reimburse the bank for the fine it paid to the KPWiG. The

[11] The new Companies Act was adopted September 15, 2000 and entered into force January 1, 2001. A German translation of the Act can be found in (Breidenbach 2001).
[12] I Aca 322/98, November 5, 1998.
[13] Under Polish law, a corporation may have a two-tier management structure, consisting of a management board and a supervisory board. See Art. 377 CC. A corporation with share capital of less

defendants argued that they had fulfilled their obligations under the law by delegating the task of supervising the share issuance to one of their members and therefore were not liable. The court of first instance denied a cause of action. Upon the plaintiff's appeal, the Katowice Court of Appeal reversed the decision. The official summary of the court ruling states:

> The care of a diligent trader should include: for seeing the results of planned actions, undertaking all possible factual or legal measures in order to fulfill the obligation undertaken, showing foresight, conscientiousness, carefulness and care in order to achieve the results in accordance with the company's interests. A large degree of independence of a brokerage house and its financial and organizational separation, which allowed it to make decisions by itself, did not exclude it from the supervision of the bank, and the manager of the office was appointed and dismissed by the bank's management board. To designate one of the members of the bank's management board to supervise the activities of the brokerage house should normally not release the remaining management board members' from their responsibility in this respect.[14]

Essentially, the court replaced one highly incomplete term – the case of a diligent trader – with a set of others. These terms remain sufficiently broad to be used to hold members of the governing bodies of the corporation liable for virtually any conduct that ultimately results in harm. After all, the wording of the court's ruling suggests that they are required to undertake *all* possible factual or legal measures to further the interests of the corporation. This ruling will therefore be of little guidance to managers and lower courts when determining in future cases which actions – or failures to take action – should result in legal liability. In fact, as stated, the ruling may deter risk taking on the one hand and the delegation of responsibility to some directors on the other, if such measures fail to shield the remaining board members from liability.

The decision evidences a lack of experience with corporate decision making processes and a reluctance by the court to develop criteria to delineate actions, that

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than PLN 500,000 may choose between a supervisory board and an audit committee. Corporations that

should result in personal liability from those that should not. Given that common law courts have taken many decades to develop a body of case law in this area, this may not be surprising. The point is that transition economies need to catch up quickly in addressing the subtler problems of corporate governance, and courts need to live up to this task by developing better guidelines permissible and impermissible for corporate conduct. Procedural rules that make it difficult to bring court actions, do not facilitate this learning process. A possible solution could be to carve out aspects of fiduciary duty that lend themselves to greater specification in the law. This approach has been attempted in Russia, as will be discussed in the following section.

B. Russia

Russia enacted its law on joint stock companies in 1996. The law is based on a draft developed with the help of American legal experts Bernard Black and Reinier Kraakman (Black and Kraakman 1996; Black et al. 1996). While the law has many traces of American corporate law, it is not a simple copy. Instead, the authors sought to create a new type of corporate law, one that would rest primarily on procedural rather than substantive provisions to ensure that shareholders could self-enforce the law and would not have to rely on courts viewed as slow, incompetent, and corrupt. The law avoids broad concepts and instead attempts to spell out the rights and obligations of shareholders and directors in great detail. As in Poland, case law is only emerging. Until 1998, cases that reached the Supreme Arbitrazh Court (SAC) in Moscow were still based on the old corporate law. In the majority of cases concerning violations of shareholder rights, corporations brought actions seeking to void contracts that had been entered into in violation of provisions that required

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exceed the stipulated share capital must have a supervisory board.

approval by all members of the board or the shareholder meeting. It appears that litigation was thus used strategically by the company to escape contractual liability, not by shareholders to enforce their rights (Kursynsky-Singer 1999).

The new corporate law carved out certain aspects of the fiduciary duty principle, namely transactions in which a director or a direction affiliate has an interest. The law defines factors that suggest an "interest," establishes procedures for approving transactions where a conflict exists, and stipulates that violations of these rules result in liability vis-à-vis the company or voidance of the transactions.

Article 71 of the 1996 Russian Law on Joint Stock Companies (JSCL) states in Section 1:

> The members of a company's board of directors (supervisory board), the company's individual executive organ (director, general director) and (or) members of the company's collegial executive organ (managing board, directorate) and equally the managing organization or manager when exercising their rights and fulfilling their duties must act in the interest of the company, exercising their rights and fulfilling their duties with regard to the company in good faith and reasonableness.[15]

The SAC has not had the opportunity to determine the meaning of good faith and reasonableness. However, it has dealt with a number of cases concerning violations of statutory provisions on conflict of interest situations, Articles 81-84 of the JSCL.[16] Thus, legal provisions that stipulate in substantial detail the actions that may give rise to liability resulted in litigation, while provisions that establish management obligations in broad, ambiguous terms have not. Given the limited LMLEP of courts in civil law jurisdictions exercise in general, and in the highly positivist post-socialist

[14] Prof. Stanislaw Soltysynski provided the translation of the summary.
[15] Translations are from Black et al. (1998).
[16] Several U.S. jurisdictions have also codified conflict of interest situations. See Delaware General Corporate Law § 144. Note, however, that the Delaware law precludes the voidance or voidability of transactions concluded by interested directors, if their interest was disclosed and the transaction was overall "fair" – introducing another broad concept that requires fine-tuning by case law. For a much more detailed elaboration on conditions that lead to a conflict of interest, see § 8.60-8.63 of the Revised Model Business Corporation Act.

countries in particular, this is not surprising. Potential litigants will carefully weigh the costs of litigation against the benefits, which are highly dependent on the court's willingness to exercise LMLEP in a reasonable manner when given the opportunity.

Article 81 defines an "interest" in a company's completion of a transaction. The persons who might have an interest include the members of the board(s), or shareholder(s) holding together with affiliated person(s) 20 or more percent of the company's voting shares. An interest exists if these persons, their spouses, parents, children, brothers, sisters, and all their affiliated persons participate directly in the transaction, hold a significant stake (20 percent of voting shares) in the other party to the transaction, or occupy on official position in that party.

The effort to write a highly complete law notwithstanding, the conditions that indicate an interest all contain terms and concepts that require further interpretation. To put it differently, they remain somewhat incomplete. They require, for example, that someone must act "in the capacity of representative or intermediary." The law does not simply stipulate that "the general director" or "a member of the board," has an interest, anticipating that others may be acting as agents of the corporation and thus could find themselves in a conflict of interest situation. Thus, while the drafters attempted to write a law that carefully specifies certain conditions, many of the terms used are highly incomplete.

An interested person must disclose that interest to the supervisory board, inspection commission and auditors. Transactions that are affected by an interest must be approved by a majority vote of the company's disinterested directors. If the company has more than 1,000 shareholders, the directors making the decision must be

both disinterested and independent.[17] Moreover, it must be established that the value the company will receive for property alienated or services delivered does not exceed market value, or conversely, that the value of the property acquired or services accepted is not below market value.[18]

Violations of conflict of interest provisions have two legal consequences. First, the transaction may be deemed void (Art. 84 Sec. 1). Second, the interested person is liable *to the company* for the amount of losses caused to the company (Art. 84 Sec. 2).[19]

An action for the invalidation of contracts can be filed by shareholders as well as by the parties to the transaction, namely, the corporation and the counter – party. The SAC had to clarify that organizations that were not a party to the transaction, including the company's creditors, had no right to file for invalidation of such transactions.[20] In a recent survey of judicial practice concerning the conflict of interest provisions of the JSCL, the SAC summarized the legal issues that arose in case law.[21] In all cases the plaintiff sought to void the contract rather than to pursue liability of the interested persons. In contrast to the case law brought under the previous law, however, several cases were brought by disgruntled shareholders. A

[17] An independent director is defined as "a member of the company's board of directors (supervisory board) who is not the company's individual executive organ (director, general director) or a member of the company's collegial executive organ (managing board, directorate);" or a person "whose spouse, parents, children brothers, and sisters are persons occupying official positions in the company's management organs." Art. 83 Section 2 para 2 JSCL.

[18] See Art. 83 Section 2 para 3. The provision makes explicit reference to Art. 77 of the JSCL, which explains how to determine market value in an economy that is still in transition from a centrally planned economy: "The market value of property, including the value of a company's shares or other securities, is the price at which a seller having full information about the value of the property and not obliged to sell, would agree to sell it, and a buyer having full information about the value of the property and not obliged to acquire the property would agree to acquire it" (Art. 77 JSCL). The law provides that that market value is determined by the company's board of directors (supervisory board).

[19] In other words, Russia combines the liability rule with the property rule. See Goshen, this volume.

[20] Ibid under 17 at p. [].

[21] Obsor praktiki pazrescheniia sporov, sviazannykh s zakliucheniem khoziaistvennymi obshchestvami krupnykh sdelok i sdelok, v soverschenii kotorykh ime'etsia zainteresovannost' (Survey of practical decisions of disputes related to the conclusion of major transactions and transactions affected by

possible explanation is that the law clearly stipulates that violations of the conflict – of – interest provisions result in liability vis-à-vis the corporation, not the shareholders, and Russian law does not provide for derivative actions. Thus, it is unclear whether shareholders would indeed have standing if they sued for damages (Black, Kraakman, and Tarassova 1998).

Several decisions addressed the issue whether an interested person was in fact a party to a transaction, or a representative of that party. Thus, courts had to deal with the ambiguities the law could not fully resolve ex ante. For example, a director who bought shares of his company from an underwriter argued that he had no "interest". The court rejected the argument on the grounds that the underwriter acted on behalf of the company, not as an independent agent, and voided the contract.[22] In another case[23], Informenergo and Gala-Inform entered into a contract over parts of a building, the value of which exceeded 2 percent of Informenergo's assets. Thus, approval by the shareholder meeting was required.[24] The general director of Informenergo had an interest in the transaction by virtue of the fact that he – together with other affiliates – held over 20 percent of the stock in Gala-Inform.[25] The lower court denied an action brought by Informenergo to void the contract. It held that because the general director had authorized a third person to sign the contract on behalf of Informenergo, the director himself was neither a party to the contract nor acted as a representative, and thus a conflict – of – interest situation did not exist. The SAC reversed, explaining

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conflict of interest). Information Letter of March, 13 2001 No. 62, published in Vestnik Vyshevo Arbitrazhnovo Suda Rossiiskoi Federatsii No. 7 (2001): 72, 79 (hereinafter Information Letter No. 62).

[22] Ibid:79.

[23] Presidium Supreme Arbitrazh Court, 27 July 2000 (No. 8342/99).

[24] See Art. 83 JSCL.

[25] The general director held 40% in AOZT Flesch-Invest, which in turn held 50% in OOO Flesch and 50% in Flesch-Market. Flesch Market held 50% in OOO Tovarischestvo Flesch, which was the sole founder of Gala-Inform.

that the delegation of power to execute the contract on behalf of the company did not eliminate the conflict –of –interest situation.

Other cases addressed the question, whether the conflict – of – interest provisions apply to a transaction concluded *after* the conflict of interest situation had been eliminated or *before* it came about. In one case, the plaintiff, a close corporation, had acquired shares in a joint stock company. The general director of the joint stock company was a cofounder of the plaintiff, holding 20 percent of its stock. He sold that stake prior to the transaction in question. The court ruled that because the conflict of interest situation must exist at the time the transaction is concluded, there was no violation. The SAC explicitly stated, "by virtue of Article 81 of the Law on Joint Stock Companies an interest in the transaction has to be ascertained at the time it is entered into."[26]

In a separate case, a joint stock company concluded a contract to acquire goods from another corporation. The value of the transaction exceeded 2 percent of the corporation's assets. Within a month after entering into the agreement, the plaintiff's general director of the plaintiff corporation acquired a 20 percent stake in the seller. The court held that in these circumstances approval by the shareholder meeting was not necessary. The transaction was within the realm of ordinary business transactions and the conflict – of – interest situation arose only after the transaction had already been concluded.

Existing case law reveals that courts are still struggling with recognizing conflict of interest situations.[27] Take, for example, the following case, in which a company demanded that its bank carry out a transaction in foreign currency. The bank refused to follow the order on the grounds that it violated conflict – of – interest provisions,

[26] Information Letter op. cit at p. 80.

because the customer was also a major shareholder of the bank. A lower court ruled that the bank's refusal to execute the order was improper. The SAC, however, reversed, arguing that the transaction was in compliance with banking and currency regulations and that the bank had no right to refuse to execute the order. The ownership relations were regarded as immaterial for this decision.[28]

In part, deficient legislation can be blamed for these results. In fact, commentators have pointed out even before case law emerged that the law would give rise to ambiguities (Black, Kraakman, and Tarassova 1998). But even the best law cannot stipulate all future contingencies unambiguously, and legislating against actions that by their very nature are hard to capture in clear cut statutory provisions inevitably results in incomplete law.

C. Germany

As noted above, German corporate law is largely mandatory law, leaving less scope for opt out than corporate law in Anglo-Saxon countries. Contrary to what one might expect from a civil law jurisdiction, the law does not spell out in great detail the obligations of various stakeholders. Instead, the corporate law subjects managers to a general standard of a diligent entrepreneur.[29] Several provisions further prohibit members of the board from competing directly or indirectly with the corporation,[30] and subject credit contracts between board members and the corporation to the approval of the supervisory board.[31] These provisions have been interpreted as statutory specifications of the general duty of loyalty (Hopt and Wiedemann 1992;

[27] An alternative interpretation would be that courts are simply corrupt and use formalistic excuses to serve one party's interest.
[28] Information Letter No. 62, p. 82.
[29] § 93 Aktienggesetz (AktG).
[30] § 88 AktG.
[31] § 89 AktG.

Hueffer 1995). In theory, these provisions could have served as a focal point for courts to develop principles of corporate conduct similar to the case law that evolved in common law jurisdictions on the basis of fiduciary duties. However, a substantial body of case law has not yet developed. This can be attributed to the fact that the law does not give shareholders easy access to the courts for violations of fiduciary duties by management. The law does not provide for derivative actions, and shareholder suits against management are available only after attempts have been made to persuade the supervisory board to bring a case, and only if the legal threshold for bringing a case has been met.[32] Thus, the law clearly expresses a preference for resolving conflicts over the scope of managers' and directors' fiduciary duties internally rather than in the court room. By contrast, shareholders have a right to judicial recourse against decisions taken at the shareholder meeting, if such decisions violate their rights.[33] The difference in access to judicial recourse for conflicts between managers and shareholders on the one hand and among shareholders on the other, is clearly reflected in the volume of case law that has developed for the two types of conflicts.[34] Only rarely have courts had occasion to clarify the meaning of fiduciary duties owed by management or members of the supervisory board in publicly held companies.[35] But they have been very active, particularly over the past

[32] Until 1998, the threshold was 10 percent. It is now 5 percent.

[33] Arguably this treatment reflects the problems that arise from the ownership structure of German firms. Even large firms have a tradition of highly concentrated ownership. This allows block holders to monitor and control management (Roe 1993), but it also places minority shareholders at risk of blockholder dominance.

[34] This proposition is further supported by the fact that for limited liability companies, where judicial recourse is available, courts have developed extensive case law on the duties managers owe to shareholders.

[35] In a case decided in 1954, the German Supreme Court had to decide whether the supervisory board could dismiss the chairman of the management board on the grounds that he refused to produce a false statement on the ownership of shares in a third company. The chairman had been asked to certify that the sole shareholder of the parent company owned the shares personally, rather than by the parent company itself. Since the law allows dismissal only for cause, the question arose, whether his behavior amounted to a breach of trust, which the court denied. For details, see BGHZ 13, 188, 189. Two years later the court acknowledged the right of the supervisory board to dismiss the chairman of the

two decades, in developing case law on the duties shareholders owe to each other. At the core of the recognition of fiduciary duties among shareholders was the notion that those who are in a position to exercise substantial control rights should exercise those rights in light of the rights and interests of others. Still, it took many years for courts to acknowledge a fiduciary relationship among shareholders of a corporation. Fiduciary duties (*Treuepflichten*) had previously been recognized only in highly personal relations, such as partnerships or employee relationships (Wellenhofer-Klein 2000). In 1975, however, the German Supreme Court (BGH) recognized such a duty among shareholders for close corporations.[36] In 1988, it extended this ruling to joint stock companies in the Lynotype case.[37] In this case, a minority shareholder challenged a decision to liquidate the company that had been approved at the shareholders meeting solely by the vote of the majority shareholder. The undisputed purpose of this decision was that the majority shareholder wished to integrate certain operations of the company into its own company, but could not achieve this by way of merger, because under the law this required the consent of all shareholders.[38] Prior to the shareholders meeting, the majority shareholder had already met with the management board and discussed the details of the transaction, including the value of the assets that were to be transferred. The court held that the majority shareholder violated his duty of loyalty vis-à-vis the minority shareholders by discussing these issues without giving the minority shareholders a chance to participate in the deal or to acquire the company or its assets.

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management board on the grounds that his behavior had violated the trust relationship between management and supervisory board. See BGHZ 20, 246.

[36] ITT-Decision, BGHZ 65, 15 (1975).

[37] Linotype decision, BGHZ 103, 184 (1988).

[38] The transfer of assets has been a common strategy to circumvent the rigid requirement of unanimous approval of a merger. § 65 Umwandlungsgesetz (Transformation Law) passed in 1995 requires a qualified vote of three-fourths of the shareholders. Corporate statutes may stipulate higher majority requirements.

In 1995 the duty of loyalty was extended to minority shareholders who could exercise a veto over a decision that determined the future existence of the corporation. In the Girmes case, the court ruled that the exercise of veto power by minority shareholders at a shareholders meeting which blocked a decision that might have saved the company from liquidation, constituted a breach of their fiduciary duty vis-à-vis other shareholders. [39]

An important feature of these cases is not only that courts used the principle of the duty of loyalty to limit the powers of stakeholders with control rights vis-à-vis other stakeholders (Wellenhofer-Klein 2000), but that they employed a broad legal principle to balance the mandatory statutory law. In Linotype, the duty of loyalty was used to assess strategies designed to circumvent a unanimous vote on the winding up of the corporation. In Girmes, it was applied to mitigate the powers that arose from the supermajority requirements the law mandates for changes in corporate capital. It is interesting to note that German courts have used fiduciary duty quite differently from courts in Delaware. While in Delaware the concept has been used as the ultimate bastion of shareholders rights against the backdrop of a highly permissive corporate law, Germany courts have used the same principle to balance the rigid mandatory law. The lesson seems to be that a mandatory statutory law designed ex ante is ill equipped to regulate the complex relations among key stakeholders in the corporation. This requires a careful balancing act, which even in the eyes of civil law scholars, is best performed by the courts (Hüffer 1990; Lutter 1998).

[39] Girmes Decision, BGHZ 129, 136 (1995). When the Girmes Corporation became insolvent, a shareholder meeting was convened to decide on a 5:2 decrease in corporate capital. The editor of a shareholder rights journal obtained proxies from minority shareholders to block this decision, arguing that a ratio of 5:3 would still save the company without as much dilution of minority shareholders. Because an agreement could not be reached, the refinancing arrangement failed and the company soon entered into bankruptcy proceedings. Shareholders voting with the majority sought damages for the loss of their stake in the corporation, arguing that if the change in corporate capital had been implemented, the company would not have been bankrupted.

Our analysis of the German case law is consistent with a study by Johnson et al. (2000) who examine how courts in French civil law countries have dealt with cases in which corporate insiders used their position to transfer corporate assets either directly to themselves or to another company they control (tunneling). They point out that clear, rigid statutory rules may invite strategies that conform to the letter of the law, but dilute corporate assets in favor of the insiders. By contrast, the broad notion of fairness embedded in fiduciary duty allows courts in common law countries to assess the substantive terms of the entire transaction.

Using our framework of the incompleteness of law, we similarly argue that when it is not possible to identify ex ante the type of actions that will amount to a violation of the law, residual lawmaking powers should be allocated to courts, not left with legislatures.

III: Transplanting Fiduciary Duty

The incompleteness of law has important implications for transplanting law from one system to another. Given that neither statutory nor case law will specify all relevant contingencies, the effectiveness of transplanted law depends on how the law will be understood, interpreted, and ultimately applied by domestic institutions in the transplant country. This depends largely on how agents holding LMLEP understand and interpret the law. If law were complete, the task would me much easier. Law could give clear guidance to social and economic actors as well as to law enforcers, and thus should deter in transplant countries as effectively as in origin countries. The incompleteness of law is therefore an important element in explaining the transplant effect (Berkowitz et al. 2002), which refers to the phenomenon that recipients of legal

transplants tend to have much less effective laws and legal institutions than countries that indigenously developed their own formal legal order. The intuition behind these empirical results is that the latter (origin) countries are in a better position to make the law relatively more complete over time through adaptation, and are more effective in developing complementary law enforcement institutions than are recipients of foreign law. The incompleteness of law theory predicts that the more incomplete the law, the less effective the transplant will be. The transplantation of open-ended concepts, such as fiduciary duty, therefore seems particularly difficult, because it cannot provide clear guidance for actual behavior or as an effective deterrent against violations. A response to this problem has been to favor "bright-line" rules over broad legal concepts in legal reform projects (Hay et al. 1996). However, bright-line rules do not eliminate the incompleteness problem. They are relatively easy to draft, but are likely to over-deter, since many actions that are flatly prohibited may potentially be welfare enhancing. Another caveat is that they can be easily circumvented, implying that they may under-deter as well (See Kim and Kim, this volume). Bright line rules may limit the role courts play in applying and interpreting the law in fact they are designed to limit the courts' power. This may be sensible in areas where other institutions, such as regulators, could effectively enforce the law. In areas where this is not the case, as for violations of fiduciary duty principles, disempowering the courts may in effect disenfranchise shareholders.

Giving courts residual lawmaking powers implies taking the risk that courts will arrive at solutions that may not be desirable from either an economic efficiency or social welfare standpoint. Lack of independence and impartiality of courts is an important explanation for why some legal systems have opted to restrict the courts' lawmaking powers, or why policy makers have advised Russia to limit the role of

courts in corporate law (Black and Kraakman 1996). But this argument is only partly convincing. Courts are reactive, not proactive law enforcers, meaning that courts get involved as arbiters only when a dispute is brought before them. The most likely response to courts that are corrupt or politicized is therefore less litigation, not excessive litigation.[40]

The reactive nature of court actions limits the scope for misuse, but does not rule out the possibility that some parties may use courts strategically. Some of the Russian case law discussed above could be interpreted as a strategic use of courts by companies wishing to escape contractual liability. Courts may be more vulnerable to such pressures when dealing with open-ended standards than when dealing with clearly specified rules.[41] But this danger has to be weighed against the potential benefits of making a broader range of actions justiciable. If courts do not handle these issues, who is better placed to delineate the rights and obligations of corporate actors?

If there is no good alternative to courts, then the question becomes, if and how courts in countries that typically do not vest courts with much residual lawmaking powers could be induced to play a more active role in enforcing fiduciary principles. Simply incorporating fiduciary duty principles in statutory law is unlikely to be effective. In addition, procedural rules should be designed to give minority shareholders standing in court. Still, our survey of the emerging case law in transition economies suggests that even procedural rules may not be sufficient, at least if the law incorporates only the broad outlines of fiduciary duty principles. Instead, the law should enumerate typical actions that might be considered a violation of fiduciary

[40] Russian litigation data for commercial disputes in the first half of the 1990s suggests that this was indeed a wide spread response to a court system, whose trustworthiness was in doubt, not least because of its roots in the socialist system (Pistor 1995; Pistor 1996). In contrast to other transition economies, where litigation rates boomed after the onset of radical economic reforms, litigation rates in Russia declined by 30 percent annually in 1993 and 1994. Since 1995 the trend has been slowly reversed.

duty principles, but explicitly add that other, similar actions, should be treated by courts in the same manner.[42] Such an approach would prevent courts from hiding behind formalistically interpreted statutory law and force them to assess the merits of different cases.

None of the forgoing suggests that courts thus empowered will arrive at the same solutions as common law judges in the U.K. or the U.S. In fact, allocating lawmaking powers to courts is likely to result in greater divergence rather than convergence of the law, as judges will respond to cases brought before them, which are bound to differ from cases litigated elsewhere.

Conclusion

The major proposition of this essay is that courts should hold residual lawmaking powers over conduct that may violate the principle of fiduciary duty. The principle of fiduciary duty exemplifies a highly incomplete law. Its very nature as a residual makes it impossible to write a fairly complete law. Where lawmakers have attempted to do so, they have usually carved out only a subset of issues for which sufficient experience existed, which allowed a good approximation of issues warranting regulation. However, they have not been able to replicate the reach of the fiduciary duty principle as enforced by courts in common law jurisdictions.

In transition economies, courts may not yet be in a position to play an effective role in developing norms for corporate conduct. The scarcity of cases that have made it to the courts so far can be taken as an indicator that there is little demand

[41] In this sense, the narrow wording of the conflict of interest rules might be regarded as effective limits on judicial discretionary power.

[42] Bernard Black has indicated to the authors tells me that this approach was attempted for the Russian corporate law, but was rejected by Russian legislatures. This suggests that Russian lawmaker consciously chose to reject a structural transplant.

for their actions. However, the lack of litigation may well lie in the uncertainty about the courts' residual lawmaking powers and the lack of clear procedural rules to support litigation. Remarkably, Russia, a country where litigation rates have been comparably low, has seen the largest number of cases among transition economies on conflict of interest problems. Perhaps it has also experienced the most extensive violation of shareholder rights. An alternative explanation is that by explicitly regulating conflict of interest matters in statutory law and referring the solution of these matters to courts, the legislature confirmed that these issues were justiciable. The main function of these provisions was thus to encourage litigation by allocating residual lawmaking powers to courts. This does not mean that the law has effectively resolved all relevant issues. But the fact that private parties have responded to an explicit allocation of residual lawmaking powers is encouraging. At the same time, it is worth noting that where the scope of the courts' residual lawmaking powers was too broad, litigation has not occurred.

In sum, the Anglo-American concept of fiduciary duty may not be easily transplantable either to civil law systems or to transition economies. However, an important insight to be gained from the history of this concept in Anglo-American law is that a core feature of this concept is the allocation of lawmaking powers to courts, which exercise law enforcement powers reactively and make law ex post. A normative implication of this analysis is that reform efforts should focus on improving the courts, not on circumventing them. In addition, procedural rights should be strengthened and substantive rules should be designed to encourage, rather than discourage, litigation in the corporate realm.

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Financial assistance for the services of the editorial assistant of these series is provided by the European Commission through its RTN Programme on Understanding Financial Architecture: Legal and Political Frameworks and Economic Efficiency (Contract no. HPRN-CT-2000-00064).

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