INCOMPLETE CONTRACTS, CONTINGENT FIDUCIARIES AND A DIRECTOR'S DUTY TO CREDITORS

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[This article presents economic arguments for extending a limited form of fiduciary duty to creditors. It clarifies the two components of debtor-firm opportunism against creditors: director-opportunism and shareholder-opportunism. The analysis, carried out within the economic perspective of incomplete contracts, focuses on three elements: incomplete contracts, self-interest seeking individuals and consequential ex post opportunism. The emphasis is on suggesting that the catalyst for a fiduciary duty is the presence of opportunistic behaviour, rather than arguing that it will depend on when a firm is in, near, or in danger of insolvency.]

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I INTRODUCTION

It is now almost accepted without question, in the courts of a number of common law jurisdictions including Australia [1] and the United Kingdom, [2] that

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1 See, eg, *Grove v Flavel* (1986) 43 SASR 410; *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722 ('*Kinsela*'); *Jeffree v National Companies and Securities Commission* [1990] WAR 183; *Galladin Pty Ltd (rec and mgr apptd) v Aimnorth Pty Ltd (in liq)* (1993) 11 ACSR 23; *Spies v The Queen* (2000) 201 CLR 603.

2 See, eg, *West Mercia Safetywear Ltd (in liq) v Dodd* [1988] BCLC 250; *Facia Footwear Ltd (in admin) v Hinchliffe* [1998] 1 BCLC 218; *Re Pantone 485 Ltd; Miller v Bain* [2002] 1 BCLC

directors of a firm owe a fiduciary duty to their company to consider the interests of creditors ahead of the interests of shareholders when the firm is actually insolvent.[3] But over the years, there has also been a gradual acknowledgement by courts in various jurisdictions that directors owe a fiduciary duty to the company to consider the interests of the company's creditors as well as its shareholders when the firm is short of actual insolvency but near to, or in danger of, it.[4] In the case of *Credit Lyonnais Bank Nederland NV v Pathe Communications Corporation* ('*Credit Lyonnais*'), Chancellor Allen of the Delaware Chancery Court ruled that '[a]t least when a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers [shareholders], but owes its duty to the corporate enterprise [including creditors].'[5]

The Anglo-Australian jurisprudence on this subject can be traced back to the well-known dictum of Mason J of the High Court of Australia in the case of *Walker v Wimborne* ('*Walker*')[6] in 1976. His Honour said:

> In this respect it should be emphasized that the directors of a company in discharging their duty to the company must take account of the interest of its shareholders and its creditors. Any failure by the directors to take into account the interests of creditors will have adverse consequences for the company as well as for them.[7]

Later, in something of a controversial judgment, Lord Templeman in the House of Lords' decision in *Winkworth v Edward Baron Development Co Ltd* ('*Winkworth*') said:

> A duty is owed by the directors to the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors.[8]

266; *Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd* [2003] 2 BCLC 153 ('*Gwyer*'); *Re MDA Investment Management Ltd; Whalley v Doney* [2004] 1 BCLC 217.

3 The main reason for this is that creditors take on the role of the main residual claimant in insolvency: see, eg, Andrew Keay, 'Formulating a Framework for Directors' Duties to Creditors: An Entity Maximisation Approach' (2005) 64 *Cambridge Law Journal* 614. Even a hardened shareholder primacy advocate, Professor Jonathan Macey, accepts the fact that when insolvency occurs the interests of shareholders are subordinated to creditors: see Jonathan R Macey, 'Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective' (1999) 84 *Cornell Law Review* 1266, 1269.

4 See, eg, *Nicholson v Permakraft (NZ) Ltd* [1985] 1 NZLR 242 ('*Permakraft*'); *Re New World Alliance Pty Ltd (rec and mgr apptd); Sycotex Pty Ltd v Baseler* (1994) 122 ALR 531; *Geneva Finance Ltd (rec and mgr apptd) v Resource & Industry Ltd* (2002) 169 FLR 152 ('*Geneva Finance*'); *Gwyer* [2003] 2 BCLC 153.

5 Civil Action No 12150, 1991 WL 277613 (Del Ch, 30 December 1991) *34. Recently, the Supreme Court of Delaware in *North American Catholic Educational Programming Foundation Inc v Gheewalla*, 930 A 2d 92, 94 (Holland J) (Del, 2007) held that the creditors of a Delaware corporation may not assert direct claims for breach of a fiduciary duty owed by the corporation's directors to them when the corporation is insolvent or in the 'zone of insolvency'. The Court did not disagree with the dictum in *Credit Lyonnais*, but it has certainly limited its scope.

6 (1976) 137 CLR 1.

7 Ibid 7.

8 [1987] 1 All ER 114, 118.

All three judges recognised that when a company is in financial difficulty, some element of obligation is owed to creditors by directors at some point. Chancellor Allen was somewhat more explicit than the other judges as to where and when this occurs, stating that the duty owed to creditors (who are part of the corporate enterprise) arises in the 'vicinity' of insolvency alongside the duty owed to shareholders.[9] Within this vicinity, the board of directors is not *merely the agent* of shareholders (who are, by implication, *merely part of the principal*) but owes its duty to the corporate enterprise as a whole. In other words, directors become the agent for the corporate enterprise, which includes shareholders and creditors.[10]

While Chancellor Allen's concern was clearly directed towards the effects of the vicinity of insolvency on creditors before the firm was in actual insolvency, Mason J held that directors must look after the interests of shareholders *as well as* those of creditors. By implying that creditors may not be able to look after their own interests exclusively by other means if directors fail to do so, Mason J appears to have suggested an element of creditors' reliance on directors under certain unspecified conditions. The implication, nonetheless, is that the nature of the duty owed to creditors (upon which the creditors rely under certain unspecified conditions) is a fiduciary one arising from an agent–principal relationship.

In contrast to the other two judges, Lord Templeman's emphasis is different. He was clearly concerned with the possibility of directors being in the position to take advantage of creditors for the *benefit of directors themselves* (as opposed to, or perhaps in addition to, the benefit of shareholders) and that this fact is not sufficiently recognised. Thus, it is of interest to note that all three judges, in three different jurisdictions, suggested that the nature of the obligation to creditors is not fundamentally different from the fiduciary duty owed by an agent to a principal. This fiduciary duty is owed, if not directly, to creditors, indirectly to them through the directors' fiduciary duty to the firm.

The reason given for the shift to consider creditor interests either along with, or in substitution for, shareholder interests[11] is the gradual realisation that if the company is insolvent, in the vicinity of insolvency or embarking on a venture which it cannot sustain without relying totally on creditor funds, 'the interests of the company are in reality the interests of existing creditors alone.'[12] At this time, the shareholders are no longer the owners of the residual value of the firm[13] as they have been usurped by the creditors, whose rights are transformed

9 However, it is not possible to state categorically when the 'vicinity of insolvency' is actually reached. Like other trigger points given in case law, there is imprecision.

10 In *Credit Lyonnais*, Civil Action No 12150, 1991 WL 277613 (Del Ch, 30 December 1991) *34 fn 55, Chancellor Allen recognised the possibility of exposing creditors to the risk of opportunistic behaviour by comparing the interests of shareholders and bondholders in a firm.

11 For further discussion, see Andrew Keay, *Company Directors' Responsibilities to Creditors* (2007) 181–4.

12 *Brady v Brady* (1987) 3 BCC 535, 552 (Nourse LJ) ('*Brady*').

13 The residual owners are those whose wealth directly rises or falls with changes in the value of the company: Douglas G Baird, 'The Initiation Problem in Bankruptcy' (1991) 11 *International Review of Law and Economics* 223, 228–9; Stuart C Gilson and Michael R Vetsuypens, 'Creditor Control in Financially Distressed Firms: Empirical Evidence' (1994) 72 *Washington University Law Quarterly* 1005, 1006. This is generally supported by *Brady* (1987) 3 BCC 535. Professor Lynn LoPucki criticises the use of residual ownership: see Lynn M LoPucki, 'The Myth of the

into equity-like rights.[14] Thus, the directors are effectively playing with the creditors' money,[15] which means that the creditors may instead be seen as the major stakeholders in the company.[16]

The question that this precipitates is: should the relationship between directors and creditors be construed as one between agent and principal and, therefore, a fiduciary one? Is there a theoretical basis for such a status? If yes, should creditors be accorded the status of a principal to whom directors (as agents) owe a fiduciary duty? At what point does this status arise?

The progressive school of thought has provided provocative community-based arguments in support of a fiduciary duty being owed to creditors by directors in relation to the theory of corporate law.[17] This school bases many of its arguments on fairness.

In contrast, the law and economics school argues that efficiency is a critical or indeed the sole element in determining what approach should be taken. It advocates a contractarian approach that embraces the freedom-to-contract position — a position which presumes that individuals should be able to make whatever contracts they see fit.[18] The corollary of this latter position when combined with the neoclassical model of economics is that the question of fiduciary duty does not arise between directors and creditors as creditors are adequately protected by contracts which they enter into freely.[19] It is shareholders who should benefit from fiduciary duties; they need such duties to protect themselves because they are less able to safeguard their position through

Residual Owner: An Empirical Study' (2004) 82 *Washington University Law Quarterly* 1341. Leslie Kosmin, who was sitting as a Deputy Judge of the Chancery Division in *Gwyer* [2003] 2 BCLC 153, 178, specifically stated that creditors' interests should be paramount at the time of insolvency. Overall, the cases provide little guidance.

14 See, eg, Steven L Schwarcz, 'Rethinking a Corporation's Obligations to Creditors' (1996) 17 *Cardozo Law Review* 647, 668; R Millner, 'What Does It Mean for Directors of Financially Troubled Corporations to Have Fiduciary Duties to Creditors?' (2000) 9 *Journal of Bankruptcy Law and Practice* 201, 206–7. See generally Baird, above n 13. Whether this gives creditors a proprietary interest in the assets of the company is a matter for debate. It is suggested in *Kinsela* (1986) 4 NSWLR 722, 730 (Street CJ) that they do. Cf Sarah Worthington, 'Directors' Duties, Creditors' Rights and Shareholder Intervention' (1991) 18 *Melbourne University Law Review* 121, 141. For the view that several groups could be regarded as exposed to residual risk, see Gavin Kelly and John Parkinson, 'The Conceptual Foundations of the Company: A Pluralist Approach' (1998) 2 *Company Financial and Insolvency Law Review* 174.

15 Jonathan C Lipson, 'Directors' Duties to Creditors: Power Imbalance and the Financially Distressed Corporation' (2003) 50 *University of California at Los Angeles Law Review* 1189, 1212. See also *Brady* (1987) 3 BCC 535, 552 (Nourse LJ); Millner, above n 14, 207; Rima Hartman, 'Situation-Specific Fiduciary Duties for Corporate Directors: Enforceable Obligations or Toothless Ideals?' (1993) 50 *Washington and Lee Law Review* 1761, 1771.

16 *Kinsela* (1986) 4 NSWLR 722, 730 (Street CJ); Hartman, above n 15, 1766.

17 See Andrew Keay, 'A Theoretical Analysis of the Director's Duty to Consider Creditor Interests: The Progressive School's Approach' (2004) 4 *Journal of Corporate Law Studies* 307.

18 See, eg, David Millon, 'Communitarians, Contractarians, and the Crisis in Corporate Law' (1993) 50 *Washington and Lee Law Review* 1373, 1382; Simon Deakin and Alan Hughes, 'Economic Efficiency and the Proceduralisation of Company Law' (1999) 3 *Company Financial and Insolvency Law Review* 169.

19 Creditors are also protected by some legislation such as provisions that mandate that dividends can only be paid to shareholders from profits: see, eg, *Corporations Act 2001* (Cth) s 254T; *Companies Act 2006* (UK) c 46, ss 736, 830.

contract.[20] Of course, it is of interest to note that the law and economics school, in general, takes no issue with the directors' fiduciary duty to shareholders (even though shareholders are protected by contracts which have been entered into freely) nor with the implicit assumption that the shareholders' contracts offers insufficient protection.

Like law and economics scholarship, this article adopts an economic approach in order to address the questions posed above. However, the economic approach adopted is one that goes beyond the neoclassical model by shifting the focus of economic analysis of the firm from profit maximisation to resolving conflicts of interests between contracting parties.[21] Specifically, we seek to address the issue of directors' duty to creditors from the economic perspective of incomplete contracts.[22] Our principal aim is, first, to illustrate the fact that mainstream economic arguments can be used to support the recognition of a fiduciary duty owed to creditors by directors of the debtor-firm under certain conditions and, secondly, to propose a case in support of recognising directors' fiduciary duty to creditors on economic grounds.[23] It is worth noting that, generally speaking, those who have argued for a duty to creditors have done so from non-economic, fairness-based perspectives.[24] Thus, our secondary aim is to suggest that there is actually some degree of convergence between fairness and efficiency (or economic) arguments as far as directors' duty to creditors are concerned.

The balance of the article is organised as follows. Part II traces the way corporate law has developed in relation to the kind of obligation that directors are said to owe to creditors. Specifically, we consider whether the positive law provides that directors owe a direct, independent duty to creditors or whether directors owe their duty solely to the company, which includes, under certain circumstances, taking into account the interests of creditors. Part III, after setting out relevant principles relating to an economic analysis of law, sketches out the theoretical framework of incomplete contracting and outlines its economic implications in the context of directors' duty to creditors. A comparison is then made between the incomplete contracting arguments and the freedom-to-contract arguments often employed by the law and economics school. Part IV analyses the role of shareholders in a firm within the incomplete contracting framework and presents arguments to suggest that the fiduciary duty owed to shareholders

[20] Fiduciary duties are owed to the company as a whole: see *Percival v Wright* [1902] 2 Ch 421; *Multinational Gas & Petrochemical Co v Multinational Gas & Petrochemical Services Ltd* [1983] Ch 258. But the courts have tended to hold that this includes present and future shareholders: see *Gaiman v National Association for Mental Health* [1971] Ch 317, 330 (Megarry J); *Brady* (1987) 3 BCC 535, 552 (Nourse LJ).

[21] See, eg, Gerald T Garvey and Peter L Swan, 'The Economics of Corporate Governance: Beyond the Marshallian Firm' (1994) 1 *Journal of Corporate Finance* 139. The underlying rationale is that if profit maximisation is the outcome, conflicts-of-interests resolution must be the process.

[22] See, eg, Oliver E Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (1975); Oliver Hart and John Moore, 'Foundations of Incomplete Contracts' (1999) 66 *Review of Economic Studies* 115.

[23] For non-economic arguments, see Keay, *Company Directors' Responsibilities to Creditors*, above n 11, ch 13.

[24] See, eg, the discussion in Andrew Keay, 'Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors' (2003) 66 *Modern Law Review* 665. An exception is Razeen Sappideen in 'Fiduciary Obligations to Corporate Creditors' [1991] *Journal of Business Law* 365, who considers both economic and non-economic perspectives.

by directors can be construed as a partial solution to 'complete' the incomplete contract between directors and the firm. Finally, Part V performs a similar analysis in relation to creditors so as to establish the conditions under which creditors face (similar) incomplete contracting problems encountered by shareholders. We point out that, by implication, a creditor should be accorded the status of a principal to whom directors (as agents) owe a fiduciary duty (contingent on these conditions being met).

II CASE LAW AND THE OBLIGATION OWED TO CREDITORS

As mentioned earlier, the law concerning directors' obligations to consider creditors' interests goes back, in Anglo-Australian jurisprudence, to the case of *Walker* in 1976. Since the 1980s, Australian, UK and other Commonwealth of Nations courts have accepted the fact that directors owe some sort of responsibility to take into account the interests of the creditors when a company is in some form of financial difficulty. The law is not precise in relation to when the obligation arises. The courts have failed to specify the nature of the financial difficulty that must afflict a company before the obligation is triggered, save for the fact that it is generally accepted that the obligation definitely arises when the company is insolvent.[25] We do not intend to rehearse the law that proves the foregoing points. That has been done elsewhere.[26] What we wish to focus on is the kind of obligation that directors owe to creditors. The director owes either a direct and independent duty to creditors, or an indirect duty to creditors in that the director must consider creditors' interests as part of the duty to the company.

In *Walker*, Mason J did not state whether directors have a duty to their companies to consider creditor interests or whether directors have a distinct duty to creditors. But the dictum has been interpreted as standing for both propositions. The minority view articulated by some, such as Professor Razeen Sappideen, is

[25] See, eg, *Kinsela* (1986) 4 NSWLR 722, 730 (Street CJ); *West Mercia Safetywear Ltd (in liq) v Dodd* [1988] BCLC 250, 252–3 (Dillon LJ). For a broader discussion, see Andrew Keay, 'The Director's Duty to Take into Account the Interests of Company Creditors: When Is It Triggered?' (2001) 25 *Melbourne University Law Review* 315.

[26] See further L S Sealy, 'Directors' "Wider" Responsibilities — Problems Conceptual, Practical and Procedural' (1987) 13 *Monash University Law Review* 164; C A Riley, 'Directors' Duties and the Interests of Creditors' (1989) 10 *Company Lawyer* 87; D D Prentice, 'Creditor's Interests and Director's Duties' (1990) 10 *Oxford Journal of Legal Studies* 265, 275–6; Sappideen, above n 24; Vanessa Finch, 'Directors' Duties: Insolvency and the Unsecured Creditor' in Alison Clarke (ed), *Current Issues in Insolvency Law* (1991) 87; Ross Grantham, 'The Judicial Extension of Directors' Duties to Creditors' [1991] *Journal of Business Law* 1; Worthington, above n 14; David A Wishart, 'Models and Theories of Directors' Duties to Creditors' (1991) 14 *New Zealand Universities Law Review* 323; Keay, 'The Director's Duty to Take into Account the Interests of Company Creditors: When Is It Triggered?', above n 25; Andrew Keay, 'The Duty of Directors to Take Account of Creditors' Interests: Has It Any Role to Play?' [2002] *Journal of Business Law* 379; James McConvill, 'Directors' Duties to Creditors in Australia after *Spies v The Queen*' (2002) 20 *Company and Securities Law Journal* 4; James McConvill, '*Geneva Finance* and the "Duty" of Directors to Creditors: Imperfect Obligation and Other Imperfections' (2003) 11 *Insolvency Law Journal* 7; Anil Hargovan, 'Directors' Duties to Creditors in Australia after *Spies v The Queen* — Is the Development of an Independent Fiduciary Duty Dead or Alive?' (2003) 21 *Company and Securities Law Journal* 390; Anil Hargovan, '*Geneva Finance* and the "Duty" of Directors to Creditors: Imperfect Obligation and Critique' (2004) 12 *Insolvency Law Journal* 134; Keay, *Company Directors' Responsibilities to Creditors*, above n 11, chs 11–17.

that the dictum supports the notion that directors owe a direct duty to creditors.[27] Others have argued that his Honour merely stated that directors must, as part of their duty to their company, consider creditor interests.

Nicholson v Permakraft (NZ) Ltd ('*Permakraft*')[28] was one of the first appellate court decisions after *Walker* in which the latter case was expressly approved of. In *Permakraft*, Cooke J of the New Zealand Court of Appeal seemed to indicate that there was no direct duty when he held: 'The duties of creditors are owed to the company. On the facts of particular cases this may require the directors to consider inter alia the interests of creditors.'[29] However, later in his judgment his Honour did talk about 'duties to creditors',[30] but it is likely that he was only using the reference to duties here loosely, in the manner that many writers and judges have done in the past. Soon after *Permakraft*, the New South Wales Court of Appeal in *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722 ('*Kinsela*') was called upon to consider the issue. In delivering the leading judgment, Street CJ did not refer to 'a duty to creditors' at all. Rather, his comments appear to affirm the indirect duty concept. His Honour said that when a company is insolvent, 'the interests of the creditors' intrude',[31] but he did not suggest that directors had a duty to the creditors. The approach of Street CJ was approved of by the English Court of Appeal in *West Mercia Safetywear Ltd (in liq) v Dodd*,[32] perhaps the leading English case on the issue. However, that Court did not indicate in its comments any preference for the view that the directors owed a direct or indirect duty to creditors.

In the first Australian case that specifically considered the nature of the obligation of directors to creditors, *Re New World Alliance Pty Ltd (rec and mgr apptd); Sycotex Pty Ltd v Baseler*, Gummow J of the Federal Court took the view that the directors did not owe a direct duty to creditors. His Honour stated that the duty is 'a duty of imperfect obligation owed to creditors'.[33]

The last UK case to mention specifically the issue of direct duty was *Yukong Lines Ltd of Korea v Rendsburg Investments Corporation of Liberia [No 2]*, where Toulson J said that a director 'does not owe a direct fiduciary duty towards an individual creditor, nor is an individual creditor entitled to sue for breach of the fiduciary duty owed by the director to the company.'[34] Interestingly, his Lordship talked about no duty being owed to an individual creditor, but he did not expressly reject a duty owed to all creditors.

Meanwhile in Canada, Cullity J of the Ontario Superior Court of Justice similarly rejected the idea of a direct duty to creditors in *Millgate Financial Corporation Ltd v BCED Holdings Ltd*, even though he accepted that directors had to

[27] Sappideen, above n 24, 366.
[28] [1985] 1 NZLR 242.
[29] Ibid 249.
[30] Ibid 250.
[31] *Kinsela* (1986) 4 NSWLR 722, 730.
[32] [1988] BCLC 250, 252–3 (Dillon LJ), 255 (Croom-Johnson LJ and Caulfield J).
[33] (1994) 122 ALR 531, 550.
[34] [1998] 4 All ER 82, 99.

consider creditors' interests when the company 'is insolvent, or near insolvent, or where the impugned transactions place the corporation's solvency in jeopardy'.[35]

Perhaps the most severe damage that has been done in relation to the concept of a direct duty has been in Australia and Canada, where the highest courts in both jurisdictions have rejected a direct duty. For the first time since *Walker*, the Australian High Court had an opportunity to consider the issue in *Spies v The Queen* ('*Spies*').[36] However, the case did not turn on whether directors owed a responsibility to creditors and what the Court had to say on the topic only constituted dicta at best. The Court denied, clearly, that directors owe an independent duty to creditors.[37] The same result occurred in *Peoples Department Stores Inc (Trustee of) v Wise* ('*Peoples Department Stores*').[38] In this case, when it came before the Canadian Supreme Court (on appeal from Quebec), it was said, inter alia, that the interests of the company that directors had a duty to act for are not to be confused with the interests of the creditors or those of any other stakeholders.[39] While the Court stated that it might be appropriate for directors to take into account the interests of creditors in determining whether directors have acted in the best interests of the company, there is no duty owed to creditors, even in the case when a company is in the vicinity of insolvency.[40] The Court's decision followed a view espoused in earlier cases[41] and it effectively reversed the judgment of Greenberg J at first instance in the Quebec Superior Court, where his Honour appeared to accept the notion that directors owed a direct duty to creditors.[42]

While the view that directors only have to consider creditor interests as part of their duty to their companies has predominated, those who argue for a direct duty are not without some support. The primary support lies in a judgment of Lord Templeman in *Winkworth*, which was approved of by the other Law Lords. Lord Templeman said:

> a company owes a duty to its creditors, present and future. The company is not bound to pay off every debt as soon as it is incurred and the company is not obliged to avoid all ventures which involve an element of risk, but the company owes a duty to its creditors to keep its property inviolate and available for the repayment of its debts … A duty is owed by the directors to the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors.[43]

35 (2003) 47 CBR (4th) 278, 305.

36 (2000) 201 CLR 603.

37 Ibid 636–7 (Gaudron, McHugh, Gummow and Hayne JJ).

38 [2004] 3 SCR 461, 466 (Major and Deschamps JJ for Major, Bastarache, Binnie, LeBel, Deschamps and Fish JJ).

39 Ibid 482–3.

40 Ibid 483.

41 See, eg, *Royal Bank of Canada v First Pioneer Investments Ltd* (1980) 27 OR (2d) 352.

42 *Peoples Department Stores Inc v Wise* (1998) 23 CBR (4th) 200.

43 [1987] 1 All ER 114, 118.

The majority of commentators have certainly taken his Lordship's comment to have been advocating a direct duty to creditors.[44] The general approach adopted by his Lordship has also found some judicial approval. In fact, the Full Court of the Western Australian Supreme Court in *Jeffree v National Companies and Securities Commission*[45] expressly approved of his Lordship's words. Furthermore, while rarely referred to, Richardson J in the New Zealand decision of *Permakraft* stated that when a company was insolvent, the directors 'might be said to have a duty to [the creditors]'.[46] It must be added that his Honour did say that when a company was not insolvent, but in a financial mire, the state of affairs was more difficult to determine.

In Ireland, where there has been clear acceptance of the idea that directors can be said to owe obligations to creditors in certain circumstances, McGuinness J in *Jones v Gunn*, while not entering into a substantial consideration of whether a direct duty was owed, said that where a company is insolvent, at least, the directors owe a fiduciary duty to the creditors.[47]

The dictum of Lord Templeman has certainly been the subject of substantial academic criticism.[48] Points that can be made against the dictum representing the law are that: no authority was cited by his Lordship in support; no case law was even discussed in the judgment; and given that the comments were, in many ways, groundbreaking, they were surprisingly brief. Christopher Riley has noted that what his Lordship said could be seen as 'a novel suggestion in that it implies some sort of obligation owed by a company to its creditors over and above any contractual obligations incurred by the company in its dealings with each creditor'.[49] It is of interest that some three years after his comments in *Winkworth*, Lord Templeman, while a member of the Privy Council in *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd*, concurred with the judgment of Lord Lowry, in which the latter said: 'although directors are not liable *as such* to creditors of the company, a director may by agreement or representation assume a special duty to a creditor of the company.'[50] This statement appears to suggest that no fiduciary duty could be owed directly to creditors without some specific action on the part of directors.

There has been some suggestion that Jacobs J of the South Australian Supreme Court in *Grove v Flavel*[51] was advocating that directors owed a direct duty to creditors, for the Australian High Court said in *Spies* that *if* Jacobs J was suggesting that directors owed an independent duty, it was contrary to principle.[52] With respect, it is submitted that it is not possible to read what Jacobs J said as endorsing the concept of an independent duty. Of course, given what the

44 Keay, above n 11, 266.
45 [1990] WAR 183.
46 [1985] 1 NZLR 242, 254.
47 [1997] 3 IR 1, 22.
48 See, eg, L S Sealy, 'Directors' Duties — An Unnecessary Gloss' (1988) 47 *Cambridge Law Journal* 175.
49 Riley, 'Directors' Duties and the Interests of Creditors', above n 26, 91.
50 [1991] 1 AC 187, 219 (emphasis in original).
51 (1986) 43 SASR 410.
52 (2000) 201 CLR 603, 636–7 (Gaudron, McHugh, Gummow and Hayne JJ).

High Court said in *Spies*, if Jacobs J was endorsing a direct duty, that view would not be persuasive now.

One Australian commentator, Professor Razeen Sappideen, has sought to rely on a comment in an English judgment that predates Lord Templeman's in order to bolster the argument for a direct duty.[53] Lord Diplock in *Lonrho Ltd v Shell Petroleum Co Ltd* stated that 'it is the duty of the board to consider whether to accede to the request [for inspection of documents] would be in the best interests of the company. These are not exclusively those of its shareholders but may include those of its creditors.'[54] However, it is to be noted that the upshot of what his Lordship said is that the directors *may* have to consider the creditors. He does not appear to be suggesting an independent duty. In fact, his Lordship seems to be stating that the duty is to the company and this might involve taking into account creditor interests. If this is correct, then it is consistent with the argument that directors do not owe a direct duty, but as part of their duty to the company they have to consider the interests of creditors when some form of financial strife afflicts the company. In any event, his Lordship's statement appears to be an aside that does not provide the necessary ammunition in order to argue for a full-blown doctrine of an independent duty.

There has been some lively debate in Australia on the issue at hand. Anil Hargovan has trenchantly argued that the Australian High Court in *Spies* has finished off the notion that directors could be held to owe an independent duty to creditors,[55] while James McConvill asserts, inter alia, that while the High Court did not approve of such a duty, the judgment in *Spies* does not bar a court from finding directors liable for breach of duty on a creditor's claim.[56] The latter's argument is that 'the decision in *Spies* did not make any authoritative determination as to the nature and scope of a director's obligation to the company's creditors.'[57] Much turns on the interpretation of the judgments in *Spies*, but it is submitted that it appears unlikely that an Australian court is going to permit the idea of an independent duty in light of *Spies*. Certainly, in two Western Australian cases heard subsequent to *Spies*, the Supreme Court of Western Australia found that the High Court in *Spies* was against the notion of an independent duty owed to creditors.[58] In one of the cases, *Geneva Finance Ltd (rec and mgr apptd) v Resource & Industry Ltd* (2002) 169 FLR 152 ('*Geneva Finance*'), Heenan J said:

> the orthodox articulation of the duty is that a director of a company, especially if the company is approaching insolvency, is obliged to consider the interests of

53 Sappideen, above n 24, 387.

54 [1980] 1 WLR 627, 634.

55 Hargovan, 'Directors' Duties to Creditors in Australia after *Spies v The Queen*', above n 26; Hargovan, '*Geneva Finance*', above n 26.

56 McConvill, 'Directors' Duties to Creditors in Australia after *Spies v The Queen*', above n 26; McConvill, '*Geneva Finance*', above n 26.

57 McConvill, '*Geneva Finance*: Other Imperfections', above n 26, 9.

58 *The Bell Group Ltd (in liq) v Westpac Banking Corporation* [2001] WASC 315 (Unreported, Owen J, 19 November 2001); *Geneva Finance* (2002) 169 FLR 152. Two other recent cases have expressly approved of the dicta in *Spies*: *Johnson Matthey (Aust) Ltd v Dascorp Pty Ltd* (2003) 9 VR 171, 219 (Redlich J); *Emanuel Management Pty Ltd (in liq) v Foster's Brewing Group Ltd* (2003) 178 FLR 1, 291 (Chesterman J).

> creditors as part of the discharge of his duty to the company itself, but that he does not have any direct duty to the creditors and certainly not one enforceable by the creditors themselves …[59]

Given the opinions of the High Court in *Spies* and the Supreme Court of Canada in *Peoples Department Stores*, the direct duty argument is likely to falter in most, if not all, Commonwealth of Nations jurisdictions. It might be argued that the concept of fiduciary relationship is developing on a case-by-case basis[60] which would leave room for asserting the existence of an independent duty to creditors. However, the fact of the matter is that the predominance of the case law is against an extension of the duty to creditors.

The issue as to whether directors owe a direct or an indirect duty is not merely an academic one; it can have several practical consequences. One important practical consequence is the identity of the person who has standing to take legal proceedings for a breach of the duty. It follows that while a direct duty would enable creditors to enforce any breach of the duty, this will not be the case if the indirect duty approach is adopted instead. Rather, any enforcement can only be done by the company itself (to whom the duty is owed), a liquidator, an administrator or a receiver acting for the company.

Clearly, the positive law in Australia, the UK and elsewhere in the Commonwealth of Nations and Ireland does not at present support the existence of a director's duty to creditors.[61] We now consider whether the concept of a direct duty can stand on the basis of economic grounds thereby providing a normative basis for arguing that there should be a direct duty.

III CORPORATE LAW AND ECONOMIC ANALYSIS

The economic theory of the firm (or company)[62] regards the company as nothing more than a number of complex, private, consensual contract-based relations,[63] either express or implied, and consisting of many different kinds of relations that are worked out by those voluntarily associating in a company.[64] The parties involved in these contracts are regarded as rational economic actors, which include shareholders, managers, creditors and employees, and it is accepted that each of these constituencies endeavour in their contracting to maximise their own positions with the intention of producing concomitant

59 (2002) 169 FLR 152, 164.

60 *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41.

61 The duty also does not exist in Delaware in light of the decision in *North American Catholic Educational Programming Foundation Inc v Gheewalla*, 930 A 2d 92 (Del, 2007).

62 See, eg, Eugene Fama, 'Agency Problems and the Theory of the Firm' (1990) 88 *Journal of Political Economy* 288, 290.

63 See Michael Klausner, 'Corporations, Corporate Law, and Networks of Contracts' (1995) 81 *Virginia Law Review* 757, 759. Referring to the relations as contracts is probably incorrect. Some authors refer to the relations as bargains because some of the relations do not constitute contracts in a technical sense: see, eg, Melvin Aron Eisenberg, 'The Structure of Corporation Law' (1989) 89 *Columbia Law Review* 1461, 1487–8.

64 Frank H Easterbrook and Daniel R Fischel, 'The Corporate Contract' (1989) 89 *Columbia Law Review* 1416, 1426. The learned commentators give examples of some of the arrangements: at 1428.

benefits for themselves.[65] This scheme is usually known by the shorthand expression of 'a nexus of contracts'.[66]

While economic theory accepts that courts can fill the gaps left by incomplete contractual provisions (for instance, limited liability in corporate law provides an allocation of risk),[67] emphasis is placed on the market. According to economic theory, the market (including capital, labour and product markets) is 'the glue that holds together the nexus of contracts.'[68] The market or private ordering, so the argument goes, provides a more effective incentive for efficient contractual conduct. The structure of corporate law, according to law and economics theory, should thus be a body of default rules which the parties are entitled to choose to vary or omit.[69] In addition, the law and economics school emphasises financial economics and the need to reduce transaction costs so as to improve efficiency.[70] While providing no description of a firm's internal structure, neoclassical economic analysis then goes on to see the firm's objective as being to maximise the wealth of shareholders, who are regarded as owning the firm, by maximising profit. The interests of other parties with stakes in and contacts with the firm, such as creditors and employees, are less emphasised and assumed to be protected by contracts entered into freely.[71]

Building on the neoclassical framework, the agency theory seeks to examine the role of managers/directors inside the firm.[72] The theory regards managers or directors as the agents of the shareholders, with the latter being the principals. It suggests that mechanisms are required to ensure that the managers/directors, who are self-interest seeking parties, do not use their positions opportunistically to benefit themselves to the detriment of shareholders (a phenomenon known as

[65] See Henry N Butler, 'The Contractual Theory of the Corporation' (1989) 11(4) *George Mason University Law Review* 99; Christopher A Riley, 'Understanding and Regulating the Corporation' (1995) 58 *Modern Law Review* 595, 598.

[66] The literature considering the nexus of contracts is too voluminous to cite. But see, eg, Fama, above n 62; Easterbrook and Fischel, 'The Corporate Contract', above n 64, 1426–7. See also Stephen M Bainbridge, 'In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green' (1993) 50 *Washington and Lee Law Review* 1423, 1430, where he argues that the nexus of contracts provides us with an educated guess about the rule that most parties would embrace if they could bargain *ex ante*: one of limited liability. The nexus of contracts approach is critiqued by William W Bratton Jr in 'The "Nexus of Contracts" Corporation: A Critical Appraisal' (1989) 74 *Cornell Law Review* 407, 412, 446–65. The scheme has been referred to as 'a nexus of incomplete contracts'. For recent comments, see Deakin and Hughes, above n 18, 176–80; Iain MacNeil, 'Company Law Rules: An Assessment from the Perspective of Incomplete Contract Theory' (2001) 1 *Journal of Corporate Law Studies* 107.

[67] Michael J Whincop, 'Painting the Corporate Cathedral: The Protection of Entitlements in Corporate Law' (1999) 19 *Oxford Journal of Legal Studies* 19, 28.

[68] Henry N Butler and Larry E Ribstein, 'Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians' (1990) 65 *Washington Law Review* 1, 25.

[69] For a discussion of default rules, see, eg, Ian Ayres and Robert Gertner, 'Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules' (1989) 99 *Yale Law Journal* 87.

[70] In corporate law, transaction costs are reduced by the organisational design of the company: Oliver E Williamson, 'Transaction-Cost Economics: The Governance of Contractual Relations' (1979) 22 *Journal of Law and Economics* 233.

[71] For a critical discussion of mainstream, neoclassical theory of the firm, see, eg, Oliver E Williamson, *The Mechanisms of Governance* (1996).

[72] Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305.

managerial/director opportunism, with 'shirking'[73] being one obvious example). The mechanisms proposed by agency theory to mitigate director opportunism are, invariably, market-based. The aim is to align the interests of shareholders with those of directors/managers by mitigating potential conflicts of interests between directors and shareholders. The mechanisms include performance/profit based compensation, critical composition of independent directors on the board, the market of corporate control, the labour market for directors, as well as sufficient managerial ownership of the firm. The emphasis of agency analysis is on engendering incentive compatibility between directors and shareholders through market forces.[74]

Importantly for our discussion, advocates of economic analysis of law (both the neoclassical and agency variants) do not accept that directors should owe a duty to anyone other than shareholders.[75] Their reasons for this is that it would be counter to the shareholder maximisation doctrine as well as the notion that non-shareholders are already protected by contracts which have been entered into freely. Creditors, for example, have many avenues available to them to protect themselves and their debts.[76] First and foremost is the contract. The fact that creditors have a relationship with the company that is limited to being contractual in nature is well-established.[77] The fact that no contracts are complete is ignored and the effects of incomplete contracts are not explicated in either the neoclassical or agency analysis.

A *Incomplete Contracts*

The potentially serious problem, as now generally recognised, is that all contracts are incomplete.[78] Contracts are incomplete 'if performance of the actual terms of the agreement would leave gains from trade unrealised given the information available to the parties at the time performance takes place.'[79] The economics discipline has recognised the concept of incomplete contracts, but it is something which has been developed predominantly by the law and economics

73 This involves managers acting so that they do not have to perform their promises to their principals fully and acting for their own benefit.

74 It should be added that the market-focused agency analysis is being extended by the more recent 'law and finance' literature, which shows that the legal protection of outside investors (that is non-directors and non-major shareholders) can explain more efficient capital markets and better economic growth: see, eg, Rafael La Porta et al, 'Investor Protection and Corporate Governance' (2000) 58 *Journal of Financial Economics* 3.

75 See, eg, Mark E van der Weide, 'Against Fiduciary Duties to Corporate Stakeholders' (1996) 21 *Delaware Journal of Corporate Law* 27.

76 For a discussion of some of these avenues in the context of directors' duties to creditors, see Keay, 'Directors' Duties to Creditors: Contractarian Concerns', above n 24, 687–93.

77 Thomas Smith, 'The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty' (1999) 98 *Michigan Law Review* 214, 231.

78 Complete contracting can only exist in the ideal world of Arrow-Debreu contingent claims contracts, which are supported by the implausible twin assumptions of *perfect foresight* and *complete information* (not only for now but for all eternity). This ideal form of contracting might best be construed as a benchmark against which incomplete contracting from the real world may be understood: see, eg, MacNeil, above n 66, 112.

79 Ibid, referring to Bengt R Holmstrom and Jean Tirole, 'The Theory of the Firm' in Richard Schmalensee and Robert D Willig (eds), *Handbook of Industrial Organisation* (1989) vol 1, 61.

literature.[80] The economic perspective of incomplete contracting is based on a simple idea that the human mind is a scarce resource.[81] Hence, the mind is unable to gather, process, and understand an unlimited amount of information.[82] The limitation of the human mind may take two possible forms: cognitive limitations of contracting parties and asymmetric information between these parties. In other words, the contracting parties are not able to foresee the future perfectly, although some may know more about something than others. Because of these problems, contracting parties (who are inherently self-interest seeking)[83] cannot make complete provisions in a contract for every eventuality and all contracts are, therefore, incomplete.

The fact that the contracting parties are unable to make complete contractual provisions *ex ante* can be seen as follows. First, the inability of the contracting parties to foresee all possible future contingencies[84] (resulting from cognitive limitations) may lead to inadequate contractual provisions *ex ante*. This is the problem of bounded rationality — people are rational rather than hyper-rational. As Professor Dale Tauke has said:

> The ability of contracting parties to enter into complete contingent claims contracts in the face of complex and uncertain contingencies is limited by the 'bounded rationality' of the parties — the limits of the human mind in comprehending and solving complex problems.[85]

Secondly, there are still problems for those contingencies such as opportunistic behaviour of self-interest seeking parties that can be foreseen *ex ante* and are realised *ex post*. Not all contracting parties may be in the position to observe or recognise some of these contingencies (resulting from information asymmetry) and this may lead to disputes *ex post* ('You say I did it, but I say I did not'). Thirdly, independent third parties such as the courts and other arbitration bodies may not be able to resolve these disputes because they may not be able to verify the realised contingencies *ex post* (due to combined cognitive and informational problems).[86] Fourthly, contracts are inevitably lacking because of the high transaction costs involved in spelling out the terms to cover all possible circum-

[80] See MacNeil, above n 66, 117.

[81] In other words, foresight is, at best, *imperfect*; information, at most, *incomplete*: see, eg, Williamson, *Markets and Hierarchies*, above n 22, 79.

[82] See, eg, Karen Eggleston, Eric A Posner and Richard Zeckhauser, 'The Design and Interpretation of Contracts: Why Complexity Matters' (2000) 95 *Northwestern University Law Review* 91.

[83] Note that the assumption of self-interest seeking individuals is important. If individuals are not self-interest seeking, incomplete contracts present no serious problems. Individuals would simply do 'what is right' when the unexpected arises. Because self-interest seeking individuals are prone to opportunism should the unexpected arise, contracts need to be as complete as feasible.

[84] Frank H Easterbrook and Daniel R Fischel, *The Economic Structure of Corporate Law* (1991) 90.

[85] Dale B Tauke, 'Should Bonds Have More Fun? A Reexamination of the Debate over Corporate Bondholder Rights' [1989] *Columbia Business Law Review* 1, 16 fn 28.

[86] One example relevant to our context is the difficulty for the creditors to identify when a company is in the 'vicinity of insolvency' and/or for the courts to verify it. Creditors are prone to arguing that the company is in the 'vicinity' whereas shareholders are likely to argue that it is not.

stances (because of, again, cognitive and informational difficulty).[87] The parties might take the view that the cost of including reference to all terms might be so high that it is more efficient to map out the major parts of the agreement, leaving the non-specified issues to be resolved through some other means.[88] The fact that contracts are incomplete means that protections afforded by contracts will be inadequate.

Although expressed in different terms, lawyers have also long recognised that no contract can cover all conditions. For example, Lawrence Lessig, in commenting on constitutions, stated that 'every text must be imperfect … [A]ny text will be carried into contexts unanticipated.'[89] This is equally true for contracts. With respect to convertible bonds, Professor William Bratton Jr similarly argues that 'bondholder protective contract interpretation could never protect all bondholder expectations.'[90] In other words, contractual contexts may not be able to meet the *reasonable expectations* of contractual intent. Reflection would reveal that the underlying reasons for imperfect contractual contexts are cognitive and informational in nature: individuals are self-interest seeking mortals without the benefit of a crystal ball.

B *Incomplete Contracts and Under-Investment*

Economic arguments in the legal literature related to directors' duties to creditors so far have been mainly presented by members of the law and economics school. Because of its focus on efficiency and emphasis on voluntary contracts, the law and economics scholarship has undoubtedly made a distinguished contribution to the development and understanding of corporate law.[91] As far as directors' duties to creditors are concerned, it has been claimed that the law and economics framework is methodologically neutral. According to Judge Richard Posner, efficient company law should not favour corporate freedom or creditor protection, but endeavours to find a balance between these two objectives in a way that minimises the cost of investment.[92] The concern, however, is about the cost of an imposed legal duty (for example director's duty) relative to its benefit for trade, investment or other economic activities responsible for economic growth. In general, law and economics scholarship is wary of any imposed conditions not already adopted by the contracting parties themselves. Their basic reasoning is as follows.

In a civilised society with the rule of law, individuals are free to decide relevant contractual provisions before entering into a contract. Because of this freedom to contract, the parties would not enter into a contract where the net benefit, benefit less risk-adjusted cost, is non-positive. If any contractual

[87] Gregory Scott Crespi, 'Rethinking Corporate Fiduciary Duties: The Inefficiency of the Shareholder Primacy Norm' (2002) 55 *Southern Methodist University Law Review* 141, 141.
[88] MacNeil, above n 66, 113.
[89] Lawrence Lessig, 'The Limits of Lieber' (1995) 16 *Cardozo Law Review* 2249, 2256, 2258.
[90] William W Bratton Jr, 'The Economics and Jurisprudence of Convertible Bonds' [1984] *Wisconsin Law Review* 667, 719.
[91] See, eg, Deakin and Hughes, above n 18.
[92] Richard A Posner, 'The Rights of Creditors of Affiliated Corporations' (1976) 43 *University of Chicago Law Review* 499, 509.

provision, namely a director's duty, is needed, the contracting parties would themselves have included it in the contract. Similarly, if the duty is not included, it is because its contribution to total contractual cost exceeds its contribution to total contractual benefit. Hence, the rhetorical question is asked: why should the government or the courts impose a legal duty that individuals themselves have chosen not to put into their contracts?

The provocative arguments of the contractarian approach favoured by the majority of law and economic scholars are, however, predicated on certain assumptions in the neoclassical economic model.[93] These are, specifically, that the assumptions of perfect foresight and complete information about the future allow for complete contracting of the ideal Arrow-Debreu kind. Complete contracting can only exist in the ideal world of Arrow-Debreu contingent claims contracts, which are supported by the implausible twin assumptions of perfect foresight and complete information (not only for now but for all eternity). However, in the real world with cognitive and informational limitations, these assumptions are unrealistic. Once we accept this, and the fact that contracts are incomplete and that individuals remain self-interest seeking, the law and economic arguments need to be modified. The main reason is that if there are too many gaps (or too much risk) in a contract for comfort and the contracting parties cannot 'complete' the contract to an acceptable degree, the risk of *ex post* opportunism is too great. Consequently, parties would abandon certain contracts and forego certain economic activities, such as equity investing or corporate lending. At the limits, incomplete contracting problems, if severe and left unaddressed by other supporting devices and mechanisms, can lead to serious under-investment and constitute material impediments to trade. This can in turn hamper economic growth and that is adverse to wealth creation and social wellbeing. In addition, the fact that contracts are incomplete explains the relevant role of corporate governance as well as the need for conflict resolution in firms.[94]

C *Incomplete Contracts and Legal Liability*

The freedom to contract notwithstanding, it should be noted that it has long been accepted in the economic literature that contractual provisions cannot resolve all issues in the contract between directors and its shareholders (via the firm).[95] Basically, the literature accepts the essential validity and necessity of contracts, such as those for directors, but posits that additional corporate governance devices or mechanisms are required to support and/or enhance the viability of these contracts (or to 'complete' these contracts). These mechanisms may come in different forms, which include incentive compatible compensation,

93 See, eg, Williamson, *Markets and Hierarchies*, above n 22, 79.

94 Ramesh K S Rao, David Simon Sokolow and Derek White, 'Fiduciary Duty a la *Lyonnais*: An Economic Perspective on Corporate Governance in a Financially-Distressed Firm' (1996) 22 *Journal of Corporation Law* 53, 56.

95 This literature, known as agency cost literature, is voluminous: see, eg, Armen A Alchian and Harold Demsetz, 'Production, Information Costs, and Economic Organization' (1972) 62 *American Economic Review* 777; Jensen and Meckling, above n 72; Fama, above n 62, 290; Easterbrook and Fischel, 'The Corporate Contract', above n 64, 1426–7.

independent board directors, takeover markets and managerial labour markets. Professor Michael Jensen, the noted financial economist, observes that neither the financial markets nor internal corporate governance mechanisms are sufficient to ensure that directors serve shareholders' interests.[96] Indeed, he suggests that the imposition of legal liability on directors may be used as an additional mechanism to overcome, at least partially, the inadequate contractual and other corporate governance provisions.[97]

In other words, legal liability may be used as an additional device to *complete* the incomplete contracts between the firm and directors as well as between the firm and shareholders. But such a legal liability already exists. It is the director's fiduciary duty owed to shareholders.

IV DIRECTOR'S DUTY TO SHAREHOLDERS

A *The Origins and Basis of the Duty*

The original notion of fiduciary duties is a product of the law of equity and is concerned with the duty of a person to serve the interests of another person where the first person is in a discretionary position of trust.[98] Despite the fact that the fiduciary relationship has been an element in Anglo-Australian law for over 250 years,[99] it is based on what still remains an elusive concept.[100]

There are potential conflicts resulting from the agent's ability and possible incentive to use the *discretion* afforded by the principal for the agent's own interests in conflict with those of the principal whom the agent should serve (self-interest seeking agent opportunism). These conflicts were traditionally found between trustees and beneficiaries in trusts. The trustee's fiduciary duty to beneficiaries (a legal liability based on equitable principles) is to ensure that trustees serve the interests of the beneficiaries. Gradually, the notion of fiduciary duty was extended to other relations, such as lawyer–client, doctor–patient, and directors–shareholders (via the firm).

If viewed from the neoclassical economic model of complete contracting within the freedom-to-contract perspective, the notion of fiduciary duty does look a little odd (despite the fact that the law and economics school takes no issue with this). Why must the provisions of a trust give trustees a discretion? Why can the settlor of the trust not include sufficient contractual provisions in the contract with the trustee (along with perhaps other non-contractual but supporting provisions such as the labour market for good trustees) to ensure that

96 See generally Michael C Jensen, 'The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems' (1993) 48 *Journal of Finance* 831.

97 Ibid 864.

98 See *Re Smith & Fawcett Ltd* [1942] Ch 304, 306, 308 (Lord Greene MR). See also Deborah A DeMott, 'Beyond Metaphor: An Analysis of Fiduciary Obligation' (1988) *Duke Law Journal* 879, 880–1.

99 The roots of fiduciary duties are explained in *Woodhouse v Meredith* (1820) 1 Jac & W 204, 213; 37 ER 353, 356. See also Robert Cooter and Bradley J Freedman, 'The Fiduciary Relationship: Its Economic Character and Legal Consequences' (1991) 66 *New York University Law Review* 1045, 1045–6.

100 DeMott, above n 98, 879.

the trustee serves the interests of the beneficiaries without the need to allow for any discretion? If the discretion enjoyed by trustees (directors) enables them to serve their own interests in conflict with beneficiaries' (shareholders') interests, then why cannot beneficiaries (shareholders) take away this discretion through specific contractual provisions? After all, shareholders, like any party, are free to make contractual provisions in order to protect themselves.

It is only somewhat curious that these questions have never been asked by the law and economics scholarship. If viewed from the incomplete contracting perspective, the reason is simple. The asymmetric and discretionary position of trust, occupied by fiduciaries, results from the inability of the principals to devise complete contracts for the fiduciaries. For example, it is impossible for a settlor to specify exactly and completely, *ex ante* and before the settlor dies, what the trustee should do in every eventuality for beneficiaries over the next 10–15 years. This inability can be easily explained by obvious cognitive and informational limits on the part of the settlor. Thus, the principal–agent problem is, in effect, an incomplete contracting problem. The notion of a fiduciary duty can therefore be construed as a legal provision (along with other provisions) to complete an incomplete contract between the principal and agent, to a degree that the contract remains viable (namely the risk of *ex post* opportunism is manageable or reasonable).

If contracts are incomplete, then the provisions may not be able to meet the reasonable expectations of the contracting parties. In these situations, a fiduciary duty imposed on agents can be valuable because it makes incomplete contracts sufficiently complete by meeting reasonable expectations. Consequently the economic analysis of law approach views fiduciary duties legally imposed as contractual, for they can be used to complete a contract.[101] It is said that 'the fiduciary principle is fundamentally a standard term in a contract'.[102] Providing a fiduciary duty to shareholders is 'an alternative to elaborate promises and extra monitoring.'[103]

B *Fiduciary Duty to Shareholders: A Closer Examination*

The economic analysis of law approach takes the view that 'the economic function of fiduciary duties is to regulate the complex web of agency relationships which comprise the structure of the corporate enterprise.'[104] Put another way, fiduciary duties, in law and economics thinking, are a contractual 'device uniquely crafted to fill in the massive gap in this open-ended bargain between

[101] Frank H Easterbrook and Daniel R Fischel, 'Contract and Fiduciary Duty' (1993) 36 *Journal of Law and Economics* 425, 427; Easterbrook and Fischel, *The Economic Structure of Corporate Law*, above n 84, 92.

[102] Frank H Easterbrook and Daniel R Fischel, 'Corporate Control Transactions' (1982) 91 *Yale Law Journal* 698, 702.

[103] Easterbrook and Fischel, *The Economic Structure of Corporate Law*, above n 84, 92.

[104] Sappideen, above n 24, 382, referring to Easterbrook and Fischel, 'Corporate Control Transactions', above n 102, 700.

shareholders and corporate officers and directors.'[105] Essentially, the relationship between directors and shareholders is widely regarded as fiduciary in nature; it is a duty of loyalty and good faith.[106] A duty of loyalty in the context of a company mandates that a director subordinates their interests to that of another. According to Millett LJ in *Bristol and West Building Society v Mothew*, '[t]he principal is entitled to the single-minded loyalty of his fiduciary … he may not act for … the benefit of a third person without the informed consent of his principal.'[107] This fiduciary duty to act in good faith and to deal fairly has long been accepted by legal scholars of almost every persuasion, as well as those in the law and economics school.[108]

It is often overlooked that directors and shareholders of a firm do not have a direct contract with each other, very much in the same way that trustees and beneficiaries of a trust do not have a direct contract with each other. The contract of both the directors and the shareholders is with the firm. Directors discharge their duty directly to the firm and, in doing so, indirectly to shareholders who are part of the firm. While many will argue that the beneficiary of a director's fiduciary duties is the company,[109] in an economic analysis of law shareholders are seen as 'the exclusive and direct beneficiaries of the fiduciary duty'[110] because the shareholders own the company.[111] Hence, a duty to the company is perceived in an economic analysis of the law as equivalent to a duty to shareholders. But if directors can owe a fiduciary duty to shareholders, then why cannot such a duty be owed to creditors as well? What makes shareholders

[105] Jonathan R Macey, 'An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties' (1991) 21 *Stetson Law Review* 23, 41.

[106] *Bristol and West Building Society v Mothew* [1998] Ch 1, 18 (Millett LJ).

[107] Ibid.

[108] It is outside the scope of this article to consider in depth what a fiduciary duty is and what it involves: see further R P Austin, H A J Ford and I M Ramsay, *Company Directors: Principles of Law and Corporate Governance* (2005) 210–13; Brenda Hannigan, *Company Law* (2003) 225–95; Paul L Davies, *Gower and Davies' Principles of Modern Company Law* (7th ed, 2003) 380–423.

[109] The issue — to whom do directors owe fiduciary duties? — is one of the most basic in corporate law: Richard A Booth, 'Stockholders, Stakeholders, and Bagholders (or How Investor Diversification Affects Fiduciary Duty)' (1998) 53 *Business Lawyer* 429, 429.

[110] Smith, above n 77, 218. However, to enforce a breach of duty, shareholders must initiate derivative proceedings against directors on the part of the company.

[111] This view is probably most associated with Milton Friedman: see 'The Social Responsibility of Business Is to Increase Its Profits', *The New York Times* (New York), 13 September 1970, section 6, 32–3. Adolf A Berle Jr and Gardiner C Means referred to shareholders as owners in their seminal work, *The Modern Corporation and Private Property* (1932) 8–9. See also Robert Hessen, 'A New Concept of Corporations: A Contractual and Private Property Model' (1979) 30 *Hastings Law Journal* 1327, 1330; Oliver Hart, 'An Economist's Perspective on the Theory of the Firm' (1989) 89 *Columbia Law Review* 1757, 1765; Melvin A Eisenberg, 'The Conception That the Corporation Is a Nexus of Contracts, and the Dual Nature of the Firm' (1999) 24 *Journal of Corporation Law* 819, 825–6. The view has been espoused in the UK by the Committee on the Financial Aspects of Corporate Governance, *Report of the Committee on the Financial Aspects of Corporate Governance* (1992) 48 ('*Cadbury Report*'); Confederation of British Industries, *Boards without Tiers: A CBI Contribution to the Debate* (1996) 8. This view has been criticised by many: see, eg, Martin Lipton and Steven Rosenblum, 'A New System of Corporate Governance: The Quinquennial Election of Directors' (1991) 58 *University of Chicago Law Review* 187, 195; Paddy Ireland, 'Capitalism without the Capitalist: The Joint Stock Company Share and the Emergence of the Modern Doctrine of Separate Corporate Personality' (1996) 17 *Journal of Legal History* 41.

'special' enough to warrant the extraordinary treatment of directors' fiduciary duties? In other words, what sets shareholders apart from other constituents of the firm?

The answer given by an economic analysis of law would generally be that the shareholders' role is one of residual claimants.[112] In comparison with the contracts of other constituents, the shareholders' contract with the firm is the most incomplete — it is more open-ended. As residual risk-bearers, shareholders are the last in line to receive cash flows generated by the firm and yet it is the directors who are in actual control of the firm (and self-interest seeking).

This is the old issue of ownership without control, first identified by Adolf Berle and Gardiner Means.[113] Major strategic and operational decisions are largely within the discretion of directors because many companies have a provision in their constitution which permits the directors to exercise all of the powers of the company save for those powers which the *Corporations Act 2001* (Cth) or those powers which the constitution requires the general meeting to exercise.[114] For example, how much dividend is paid to shareholders and how much is kept as retained earnings are decisions entirely within the discretion of directors as part of their function of managing the business of the company. The declaration of dividends, unlike the payment of interest to creditors, is entirely discretionary and not legally enforceable.[115]

One main (if not the only) justification for this wide director discretion is that to run a modern firm successfully, complex and difficult decisions are required. As such, detailed contractual provisions to specify what the directors should do under particular conditions is something that is not feasible and wide discretion is accorded to directors so as to facilitate decision-making. Within the perspective of incomplete contracting, the justification for this vast discretion given to directors can be explained by the difficulties involved in both contractually specifying *ex ante* how these decisions should be made and contractually evaluating (or second-guessing) how these decisions should have been made *ex post*. The difficulties can be attributed to the cognitive and informational limitations of the contracting parties (an incomplete contracting justification).

Shareholders' role as ultimate residual risk bearers, who do not have the benefit of control in a firm, makes them most reliant on, and most vulnerable to, the actions of self-interest seeking directors. This sets them apart as a special group. However, their reliance and vulnerability in and of themselves do not automatically justify directors' fiduciary duties being owed to them. Such duties would be

[112] It has been argued that the owing of duties to shareholders can in fact be based on moral grounds: see, eg, Alexei M Marcoux, 'A Fiduciary Argument against Stakeholder Theory' (2003) 13 *Business Ethics Quarterly* 1. Many holding to a stakeholder theory approach to corporate law take the view that there is nothing that entitles shareholders to be owed fiduciary duties: see, eg, John R Boatright, 'Fiduciary Duties and the Shareholder-Management Relation: Or, What's So Special about Shareholders?' (1994) 4 *Business Ethics Quarterly* 393.

[113] See Berle and Means, above n 111.

[114] This kind of provision is identical to the replaceable rule contained in s 198A(2) of the *Corporations Act 2001* (Cth). In the UK, many companies include an article that is based on art 70 of Table A in the *Companies (Tables A to F) Regulations 1985* (UK), which is similar in effect to s 198A(2).

[115] A dividend is enforceable once it has been declared: see *Re Accrington Corporation Steam Tramways Co* [1909] 2 Ch 40.

unnecessary in two circumstances. The first circumstance is if directors' contracts with the firm can specify what they need to do in regard to shareholders under specific conditions. The second circumstance is if contract alone is insufficient for the task at hand, other control devices (such as incentive compatible compensation, independent directors, takeover markets or managerial labour markets) can themselves, or as supporting mechanisms to the contract, accomplish the task. We suggest that the fiduciary duty owed to shareholders by directors is necessary because of two shortcomings of the incomplete contract between the firm and its directors (and other supporting devices/mechanisms). First, the incomplete contract is unable to specify contractually how directors may run the firm successfully and with due regard to shareholder interests under different conditions (thus the need for director discretion). Secondly, the incomplete contract is unable to address contractually shareholders' concerns about their reliance on, and vulnerability to, the discretionary actions of self-interest seeking directors. We would also point out that had the fiduciary duty not been imposed, many equity investors in the past may have simply refrained from investing in firms, leading to under-investment and reduced economic development.

V Directors' Duty to Creditors in a Debtor-Firm

It has been pointed out that directors of a debtor-firm do not have an explicit contract with company creditors. The contracts of directors and creditors are directly with the debtor-firm rather than between themselves. Directors in general also do not have an explicit contract with shareholders and yet directors who serve the firm are recognised as owing a fiduciary duty to shareholders.[116] To assess whether, and when, directors of a debtor-firm should owe a duty to creditors, our approach is to compare and contrast the contractual relation of shareholders to the firm which has risky debt, with the contractual relation of creditors to this debtor-firm and examine the implications for directors.

We submit that the contract between creditors and the firm is much more complete than the contract between shareholders and the firm in several ways. First, whereas the firm is under no obligation to pay dividends, cash payments such as interest payments to creditors are legally enforceable claims. The failure to make a single payment can usually trigger default which would initiate a sequence of legally enforceable actions that might well precipitate insolvency proceedings, such as the presentation of an application to wind up the debtor company. Secondly, creditors, being senior claimants with fixed claims, bear less risk in general than shareholders who are residual claimants and last in line for any payment. Thirdly, the contract between creditors and the debtor-firm is less risky than the contract between shareholders and the firm, as mechanisms (such as inserting covenants in the contract or taking security) are generally and proportionally more effective in protecting creditors than shareholders. The *more*

[116] This is owed to shareholders as a group and not to individual shareholders: see *Percival v Wright* [1902] 2 Ch 421; *Multinational Gas & Petrochemical Co v Multinational Gas & Petrochemical Services Ltd* [1983] Ch 258; *Grove v Flavel* (1986) 43 SASR 410, 417 (Jacobs J); *Peskin v Anderson* [2000] BCC 1110; affd [2001] BCC 874.

complete a contract between creditors and the debtor-firm is (in comparison with the contract between shareholders and the firm), the lesser a concern the discretion of directors of the debtor-firm is for the creditors. This discretion is required for the success of the firm but can be used to serve directors' own interests.

Because of the better protection that contracts may provide, creditors (but not all of them)[117] have relatively less to fear from directors of the debtor-firm than shareholders do. However, less concern does not mean that there is no concern. Rather, the relevant question becomes whether creditors' concerns remain sufficient to warrant the uniform imposition of some additional legal duty on the debtor-firm (namely a directors' duty to creditors). Sufficient concern in this context involves the fulfilling of creditors' reasonable expectations without the imposition of an additional legal duty.

A *Creditor Protection and Debtor-Firm Opportunism*

Although more complete than the contract between shareholders and the firm, the contract between creditors and the firm with risky debt remains incomplete, as with all contracts.[118] Creditors are clearly, like others, not able to foresee all contingencies *ex ante*. Specifically, contractual provisions (along with protections) may be incomplete in addressing opportunism that can arise from the debtor-firm finding itself in an unforeseen contingency (debtor-firm opportunism). Opportunism occurs when a party (X) to a contract behaves in such a way that is contrary to the other party's (Y's) understanding of the contract, but the actions are not necessarily in breach of an express term of the contract. The result is a transfer of wealth from Y to X.[119] Generally speaking, as demonstrated in the ensuing discussion, opportunistic behaviour can be subtle because it is often difficult to detect and it might be masked as legitimate conduct. The consequence is that it may only be possible to ascertain such conduct at a high cost.[120]

As far as creditors are concerned, we suggest that there are two possible components in debtor-firm opportunism: shareholder-opportunism and director-opportunism. In other words, creditors may lose out because of potential conflicts of interest involving both self-interest seeking shareholders and self-interest seeking directors in a debtor-firm.

[117] See Keay, 'Directors' Duties to Creditors: Contractarian Concerns', above n 24.

[118] It should be noted that Riz Mokal argues that the British wrongful trading provisions (under s 214 of the *Insolvency Act 1986* (UK) c 45) can be seen as providing something that would be accepted by all parties if they had the opportunity to bargain *ex ante* and so fill the gaps in contracts: Riz Mokal, 'An Agency Cost Analysis of the Wrongful Trading Provisions: Redistribution, Perverse Incentives and the Creditors' Bargain' (2000) 59 *Cambridge Law Journal* 335. The same argument might be applied in respect of the Australian equivalent of wrongful trading — insolvent trading under s 588G (and following sections) of the *Corporations Act 2001* (Cth).

[119] Timothy Muris, 'Opportunistic Behaviour and the Law of Contracts' (1981) 65 *Minnesota Law Review* 521, 521.

[120] Ibid 525.

1 *Shareholder-Opportunism*

Research in financial economics suggests that shareholder interests can at times be in direct conflict with creditor interests in a firm with risky debt. As a group, creditors' payoff structure is different from that of shareholders because of the asymmetric payoff structure. This is responsible for the two forms of agency costs of debt.

First, creditors, as fixed claimants, do not share the upside gains with shareholders if the company does really well and profits substantially and yet they must bear any downside loss. As a result, shareholders at times may choose to take excessive risk at the direct expense of creditors in the hope of realising higher returns and, in the process, running the risk of betting the company away (the asset substitution problem).[121] Secondly, the claims of creditors, being in the position of more senior claimants than shareholders, must have their claims met first before those of shareholders. As a result, shareholders will refrain from investing in certain projects with positive net present value because the net present value generated by these projects, though positive, will not produce sufficient benefits that will go to shareholders, who are more junior claimants (the under-investment problem).[122] Both the asset substitution and under-investment problems result from a conflict of interests between shareholders and creditors in a firm with risky debt, and result in shareholder opportunism, which is potentially detrimental to creditors in a debtor-firm. The asset substitution problem is more serious because it amounts to using creditors' money to bet on risky projects for the benefit of shareholders. The under-investment problem, although less so, is also serious because to forego positive net present value projects merely because shareholders cannot share the gains can increase the overall default risk of the debt.

2 *Director-Opportunism*

Related to the conflict of interest problem between creditors and shareholders is the conflict of interest problem between creditors and directors. The conflict of interest problem between creditors and directors in a debtor-firm (director-opportunism) is conceptually no different from the conflict of interest problem between shareholders and directors: directors simply seek to serve their own interests whenever possible. What is different, as far as creditors are concerned in a debtor-firm, is the fact that directors owe fiduciary duties to shareholders and not creditors. As fiduciaries to shareholders, directors are duty-bound to use their discretion to defend shareholder interests when shareholders' interests are in conflict with those of creditors; thus they act as agents for shareholder-opportunism. As self-interest seeking parties, directors may also

[121] Jensen and Meckling, above n 72. See also Clifford Smith and Jerold Warner, 'On Financial Contracting — An Analysis of Bond Covenants' (1979) 7 *Journal of Financial Economics* 117, 119.

[122] Stewart C Myers, 'Determinants of Corporate Borrowing' (1977) 5 *Journal of Financial Economics* 147. See also Rene Stulz and Herb Johnson, 'An Analysis of Secured Debt' (1985) 14 *Journal of Financial Economics* 501; Elazar Berkovitch and E Han Kim, 'Financial Contracting and Leverage Induced Over- and Under-Investment Incentives' (1990) 45 *Journal of Finance* 765.

use their discretion to benefit themselves as well and, again, to the detriment of creditors (director-opportunism). Naturally, director-opportunism may be carried out in the guise of serving shareholder interests.

Of course, creditors can and do address some of these problems *ex ante* through contractual provisions (such as covenants) and market-based provisions (such as higher risk premiums). Because of cognitive and informational constraints, these provisions may be insufficient. After all, directors are in *ex post* control of the firm and they owe fiduciary duties to shareholders. The ability of covenants to restrict *ex post* director discretion on investment decisions is imperfect and incomplete. The market can only set interest rates and risk premiums based on the *ex ante* credit rating of the firm. Should the firm incur excessive risk *ex post* either because it takes on very risky projects and/or forgoes projects with positive net present value, adjustments of credit rating cannot normally affect the contractual terms of existing creditors retrospectively.

The above analysis that suggests contractual and other supporting provisions may not be able to protect creditors from debtor-firm opportunism (including shareholder-opportunism as well as director-opportunism) in situations where creditors' interests are in conflict with some of those in the debtor-firm. Thus, if the potential conflict of interest problems between debtor-firm and creditors suggest serious *ex post* debtor-firm opportunism, the gaps in the contract between creditors and the debtor-firm may be too risky for comfort. And if additional mechanisms are not found to 'complete' the contract to a reasonable degree, creditors may be wise to avoid lending altogether. In other words, debtor-firm opportunism, if severe and unaddressed, may lead to under-investment in the aggregate; that is neither fair nor efficient. It is in these situations, we suggest, that a legal response, in some form of a directors' duty to creditors, may be warranted on economic grounds. It should be noted that a legal response would need to address both director-opportunism and shareholder-opportunism in the debtor-firm.

3 *Reasonable and Legitimate Expectations*

The legal concept of reasonable and legitimate expectations becomes relevant in our context.[123] The concept in essence is a contract-based idea, the object of which is to fill the gaps in an incomplete contract. It involves asking what reasonable parties would have wanted to have included in their contract had they thought about the issue.[124] The enforcement of reasonable and legitimate expectations can have benefits, both from efficiency and fairness viewpoints.[125]

When creditors lend to a firm, it is reasonable to expect that there is a risk that they will not see a return on their money. After all, an investment in debt is

[123] It is a concept that has been considered in cases brought under the *Corporations Act 2001* (Cth) s 232 where there are allegations of oppression, and under the *Companies Act 2006* (UK) c 46, s 994 (see its predecessor, *Companies Act 1985* (UK) c 6, s 459), where there are claims that a company's affairs have been conducted in an unfairly prejudicial way: see, eg, the decision of the House of Lords in *O'Neill v Phillips* [1999] 2 All ER 961.

[124] Lawrence Mitchell, 'The Fairness Rights of Corporate Bondholders' (1990) 65 *New York University Law Review* 1165, 1224–5.

[125] One could argue that if it is not fair, it cannot be efficient, at least not in the long run.

inherently risky in a competitive business environment. However, debtor-firm opportunism (both director-opportunism and shareholder-opportunism) is a form of bad faith behaviour because it represents a form of uncompensated wealth-transfer from creditors to directors and/or shareholders of the debtor-firm. Since it would be against the reasonable and legitimate expectations of creditors for the debtor-firm to take advantage of creditors in this way, it is reasonable to expect that that form of behaviour is prevented from contributing to the risk of debt. If these expectations are not met, then creditors can reasonably expect that directors of the debtor-firm would be held responsible. But what should the legal response be?

B *The Commercial Law Obligation of Good Faith*

One method, short of imposing on directors a full-blown fiduciary duty to creditors, is a legal response that already exists in the United States, but not in Australia or the UK — the obligation of good faith in commercial law.[126] According to some legal scholars, the obligation of good faith in commercial law goes a long way already to meeting a firm's obligation to creditors.[127] The analysis below assesses whether it addresses both the problem of director-opportunism and the problem of shareholder-opportunism.

The commercial law obligation of good faith in some jurisdictions, as applied in lending relationships, can be construed as a commercial law response to address the problem of opportunistic discretion resulting from incomplete contracts.[128] The obligation of good faith in commercial law originates from the common law principles of fairness and, in the US, it is entrenched in the *Uniform Commercial Code* ('UCC').[129] The intention under the UCC is to construe agreements in a 'manner that is fair and reasonable under the circumstances.'[130] Similarly, there is a requirement that, at a minimum, conduct must not be manifestly unreasonable — something that is akin to unconscionability.[131] Moreover, under the UCC, the notion of good faith applies effectively to any creditor-debtor relationship.[132] The obligation of good faith has been described, in the context of a lending relationship (between the bondholders and the firm), to mean, among other things,

[126] There is a voluminous amount of literature (and too much to cite in full) dealing with good faith in the context discussed: see, eg, E Allan Farnsworth, 'Good Faith Performance and Commercial Reasonableness under the *Uniform Commercial Code*' (1963) 30 *University of Chicago Law Review* 666; Robert Summers, '"Good Faith" in General Contract Law and the Sales Provisions of the *Uniform Commercial Code*' (1968) 54 *Virginia Law Review* 195; James Stankiewicz, 'Good Faith Obligation in the *Uniform Commercial Code*: Problems in Determining Its Meaning and Evaluating Its Effect' (1973) 7 *Valparaiso University Law Review* 389; Harold Dubroff, 'The Implied Covenant of Good Faith in Contract Interpretation and Gap-Filling: Reviling a Revered Relic' (2006) 80 *St John's Law Review* 559.

[127] See, eg, Schwarcz, above n 14, 658.

[128] Dubroff, above n 126, 563.

[129] UCC § 1-203 (2004).

[130] Dubroff, above n 126, 571. See also Mark Snyderman, 'What's So Good about Good Faith? The Good Faith Performance Obligation in Commercial Lending' (1988) 55 *University of Chicago Law Review* 1335, 1340.

[131] Snyderman, above n 130, 1342.

[132] See Schwarcz, above n 14, 657.

> that opportunistic behaviour should be prevented in circumstances that could not have been contemplated in advance, and that implicit rules of conduct should be recognized if they arise from widespread courses of dealing in an industry or from particular courses of dealing between specific parties.[133]

If the limited obligation of good faith in commercial law is enforced as interpreted, it would accomplish the following. First, it would impose a legal duty on the directors of a debtor-firm not to use their discretion, given for the purpose of running the firm more effectively, in order to take advantage of creditors in relation to those contingencies that occurred and could not have been specified in the contract (the lending agreement). Secondly, it would recognise the 'mutual understanding' between the debtor-firm and its creditors even if it is not explicit in the contract. In other words, the obligation of good faith can be used to balance the needs of the creditors and the business interests of the debtor-firm in situations not specified or contemplated in the contract, and to do so in a fair way that excludes debtor-firm opportunism.

Thus, it is reasonable to suggest that the obligation of good faith, if used as interpreted, can prevent directors from engaging in director-opportunism against creditors: directors do not *actively* have to serve creditors' interests but they must *refrain* from harming creditors' interests in their dealings. Because it is not a positive duty, the obligation of good faith is less onerous than the full-blown fiduciary duty, which would require, inter alia, directors to serve actively and promote the creditors' interests. As to shareholder-opportunism, the matter is more complicated. The obligation of good faith, if enforced as interpreted, does require directors to balance creditors' interests and the interests of the debtor-firm (shareholders). However, directors cannot fulfil this obligation. The reason is their fiduciary duties to shareholders. Their hands are tied. Whenever shareholders' interests are in conflict with creditors' interests, directors must defend shareholders' interests. In these circumstances, directors would either have to violate their obligation of good faith to creditors or wilfully neglect their fiduciary duties to shareholders. They cannot fulfil both obligations even though it is reasonable for creditors to expect good faith behaviour from directors on behalf of the debtor-firm.[134] The upshot, therefore, is that the obligation of good faith *cannot* prevent shareholder-opportunism.

C *Directors' Contingent Fiduciary Duty to Creditors*

It has been asserted that parties who deal by contract with a firm, such as creditors, *choose* not to rely on fiduciary duties.[135] The fact of the matter is that most creditors can only choose to lend or not to lend in the sense that they are mere 'contract takers'. From a positive law perspective, duties are only owed to the company and not to the creditors. In any event, many creditors do not possess sufficient power to demand anything other than the very basics from a contractual relationship. Judges in different jurisdictions and legal scholars of different

133 Ibid 658.

134 William Carney, 'Does Defining Constituencies Matter?' (1990) 59 *Cincinnati Law Review* 385, 390.

135 Ibid.

persuasions have long been aware of the detrimental effects of debtor-firm opportunism on creditors. The problem is of concern in corporate law, hence the controversial rulings and the ongoing debate in the legal literature. Lord Templeman in *Winkworth*, for example, was clearly concerned about the problem of director opportunism.[136] In *Walker*, Mason J was concerned about directors' inability to balance the interests of creditors with those of shareholders when the two sets of interests are in conflict.[137] By focusing on the concept of 'vicinity of insolvency' before actual insolvency, Chancellor Allen in *Credit Lyonnais* wanted to prevent or reduce the *contribution* of shareholder opportunism to the risk of insolvency *before* actual insolvency.[138] But it may also be argued that the problem of the detrimental effects on creditors has not been articulated as clearly as required before exploring possible legal remedies.

From the perspective of incomplete contracting, our analysis suggests that contractual and other supporting provisions (including the limited obligation of good faith in commercial law) are actually fairly complete in that together they provide reasonable protection to many creditors[139] in most circumstances, including the circumstances of director-opportunism.[140] These provisions, however, may be insufficient in protecting creditors when their interests are in direct conflict with the interests of shareholders in a debtor-firm or in the circumstances of shareholder-opportunism. Because existing provisions, contractual and otherwise, may be inadequate in preventing shareholder-opportunism against creditors, the imposition of a legal liability, in the form of some fiduciary duty to creditors which would provide *ex post* compensation to creditors if there were a breach of the duty, warrants serious consideration on both equity and efficiency grounds.[141]

The objective of imposing legal liability on directors should be limited to preventing shareholder-opportunism contributing to the risk of the firm's insolvency. The key is to enable directors to balance the interests of shareholders with the interests of creditors when and only when the two groups are in direct conflict. But the fiduciary duty of directors to serve the shareholders' interest at all times is a source of difficulty, as was adverted to above. One theoretical solution is to remove directors' fiduciary duty to shareholders, but this would be unwise because it would make the contract between shareholders and the firm unacceptably incomplete in that it cannot meet the *reasonable and legitimate expectations* of shareholders and would be likely to lead to an overall reduction in equity investment. Leaving shareholders open to director-opportunism against them is neither fair nor efficient.

A more feasible solution is to modify the current form of directors' fiduciary duty by introducing a limited form of duty to creditors in the following way:

136 [1987] 1 All ER 114, 118.
137 (1976) 137 CLR 1.
138 *Credit Lyonnais*, Civil Action No 12150, 1991 WL 277613 (Del Ch, 30 December 1991).
139 Examples of creditors who will not be protected include some trade creditors who lack bargaining power.
140 Director-opportunism may be preventable by the commercial law obligation of good faith.
141 Efficiency is achieved because shareholder-opportunism will lead to reduced lending and thus under-investment in equilibrium.

directors of a debtor-firm owe creditors of the firm a fiduciary duty to balance creditors' interests with the interests of shareholders whenever the two are in conflict. While the directors' fiduciary duty to shareholders is a continuing duty, the directors' fiduciary duty to creditors is contingent, limited to circumstances where shareholders and creditors are in conflict. Outside those circumstances, creditors are protected by contractual and market-based provisions. Moreover, the proposed contingent fiduciary duty of directors is not to serve the interests of creditors. Rather, it is merely to balance their interests with those of shareholders when the two are in conflict in order to prevent shareholder-opportunism from contributing to the risk of insolvency in the debtor-firm.[142]

While it is axiomatic that shareholders and creditors have divergent views about risk and returns which would make conflict between the interests of each of the constituencies unavoidable in some cases, there are a number of substantial points that can be made in favour of this kind of balancing exercise. First, resolving conflicts is an integral element of the role of a director. Some management specialists have even said that managing competing interests is a primary function of management.[143] The fact that the balancing of diverse interests is within directors' abilities and skills is something that has been recognised as far back as 1973 by a UK Department of Trade and Industry White Paper[144] and by some American courts.[145] For example, in the American decision of *Re Healthco International Inc; Brandt v Hicks, Muse & Co Inc*, the Court played down the conflict between shareholders and creditors, saying that there were not irreconcilable conflicts and the action of looking out for creditors and shareholders' interests was merely an incident of a director's fiduciary obligations.[146] Directors are fiduciaries and society regularly requires those who are fiduciaries to make balanced decisions that can be quite difficult.[147] Take for instance the trustee. Trustees have to make investment decisions sometimes with various categories of beneficiaries in mind. This can involve weighing up risk in a similar manner that is required by a director under a duty to consider creditor interests. It usually involves the steering of a middle course. And, of course,

[142] While recognising the contracting completing function of the directors' fiduciary duty, there are scholars who nonetheless oppose extending it to creditors on two grounds. First, creditors and the firm (directors and shareholders) could renegotiate *ex post*: Frederick Tung, 'Gap Filling in the Zone of Insolvency' (2006) 1 *Journal of Business and Technology Law* 609. Secondly, creditors should protect themselves *ex ante*: Stephen Bainbridge, 'Much Ado about Little? Directors' Fiduciary Duties in the Vicinity of Insolvency' (2006) 1 *Journal of Business and Technology Law* 335. We are of the view that directors' fiduciary duty should at least be considered as one of the possible mechanisms.

[143] Jeffrey Harrison and R Edward Freeman, 'Stakeholders, Social Responsibility, and Performance: Empirical Evidence and Theoretical Perspectives' (1999) 42 *Academy of Management Journal* 479, 479. Management commentators have asserted that directors are in effect to act as referees between two stakeholder groups: see Masahiko Aoki, *The Co-Operative Game Theory of the Firm* (1984), referred to in Thomas Donaldson and Lee Preston, 'The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications' (1995) 20 *Academy of Management Review* 65, 86.

[144] United Kingdom, *Company Law Reform*, Cmnd 5391 (1973) 19–20.

[145] See, eg, *Unocal Corporation v Mesa Petroleum Corporation*, 493 A 2d 946 (Del, 1985).

[146] 208 BR 288, 301 (Judge Queenan) (Bankr D Mass, 1997).

[147] Rutheford B Campbell Jr, 'Corporate Fiduciary Principles for the Post-Contractarian Era' (1996) 23 *Florida State University Law Review* 561, 593.

directors are obliged, from time to time, to balance the interests of different classes of shareholders.[148] There is the potential difference of interests between preference, ordinary and other types of shareholders. Some shareholders hold a diversified portfolio with their investment spread across a number of companies, while still others might have all their investment concentrated in the one company. In companies that are closely held, one also has the problem of the conflicting interests of controlling and minority shareholders.

VI CONCLUSION

Notwithstanding the fact that there are many who argue against extending the fiduciary duty to non-shareholders,[149] creditors' protection has long been a concern for judges and legal scholars alike, as indicated by the decisions and ongoing academic debates in the legal literature. However, we submit that this concern for creditors has not been articulated as clearly as it may have been in order to justify legal solutions, certainly when it comes to relying on economic grounds. In this article, we have presented economic arguments for extending the fiduciary duty to creditors, under defined conditions.

Our analysis is carried out within the economic perspective of incomplete contracting by focusing on incomplete contracts, self-interest seeking individuals and consequential *ex post* opportunism. The emphasis is on suggesting that the catalyst for a duty is the presence of opportunistic behaviour, rather than arguing that it will depend on when a firm is in, near, or in danger of insolvency. When contracts are incomplete (as all contracts are) and contracting individuals are self-interest seeking (as most individuals are), *ex post* opportunism on the part of the debtor-firm against creditors becomes a legitimate concern as well as a deal-breaker. A feasible way to complete the contract, to make contractual risk reasonable or manageable, is to keep in check opportunistic behaviour as far as it is feasible (rather than specifying what individuals should do in what circumstances).

Our contribution lies in using economic arguments to clarify the two components of debtor-firm opportunism against creditors: director-opportunism and shareholder-opportunism. Our proposal, that directors owe a *contingent* fiduciary duty to balance the interests of creditors with the interests of shareholders *whenever* the interests of these two groups are in conflict, is based on this economic-based clarification, and thus moves from the necessity of having to define when any obligation of directors to consider creditor interests arises. Moreover, imposing a contingent duty on directors in favour of creditors in this way acts as something supplementary to (rather than in exclusion of) other *ex ante* protections embraced by creditors that allow for 'an *ex post* settling up.'[150] This contingent duty, more qualified and less onerous than a full-blown duty, enables transaction costs to be reduced as the costs associated with the writing of

[148] See, eg, *Mills v Mills* (1938) 60 CLR 150, 164 (Latham CJ); *Re BSB Holdings Ltd [No 2]* [1996] 1 BCLC 155, 246–9 (Arden J).

[149] See, eg, Macey, 'Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective', above n 3.

[150] Sappideen, above n 24, 394.

contracts, as well as inquiry and monitoring expenses, will also be diminished. One obvious benefit is in the credible threat that creditors are entitled to bring proceedings for breach should it turn out that the directors have failed to fulfil this duty at any time before actual insolvency. Issues of implementation as well as whether to allow certain classes of creditors to opt out of this protection are beyond the scope of this article, but could usefully form the starting point for further research.