Organizational Loyalties and Models of Firms: Governance Design and Standard of Duties

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This paper makes the two following claims: 1) The legal dimension of loyalty within organizations goes beyond duties. The governance design aimed at ensuring loyalty may strongly affect standards that characterize each layer of the organization. The interaction between standards of duty and the governance dimension of loyalty should, therefore, be more tailored to specific legal forms and their functional correlation with ownership and financing. 2) There is a greater divergence than has so far been acknowledged between the function of loyalty in vertically integrated firms and in networks of small firms. This difference, created by the relationship between the duty and the governance dimensions, should have repercussions on the definitions of legal standards. In particular, it should reflect the different relationships between hierarchy, monitoring, and loyalty and the choice between prohibitory, authorization-based, and compensatory rules. The analysis concentrates on the key variables that may affect the choice between vertical and horizontal monitoring to ensure compliance with loyal behavior in two polar models: hierarchical firms and networks of small firms. This analysis reveals the importance

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of considering the governance design when defining duties of loyalty and related standards to evaluate party-related transactions in both cases but, at the same time, the necessity of using different interpretive categories.

I THE DEFINITION OF RULES GOVERNING DUTIES OF LOYALTY AND CONFLICTS OF INTEREST IN ORGANIZATIONS: IS A NEW APPROACH NEEDED?

The definition of loyal behavior and organizational loyalty is a highly debated issue that has recently undergone significant changes. Duties of loyalty within organizations are differently conceived, and they vary in both construct and scope.[1] There are quite significant differences among legal systems and, in some cases, within the same legal family.[2] Recent events have shed light on important modifications that have occurred in the past. In particular, there has been a shift in stance towards rules governing conflicts of interest, especially due to the recognition that some categories of self-dealing transactions could actually be beneficial to the organization, provided that certain fairness requirements were upheld.[3] At the same time, changes in corporate environments and closer

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1 This essay will analyze the relationship between loyalty and self-dealing. Other obligations traditionally associated with loyalty, such as covenants not to compete, duties not to deal with rivals, insider trading provisions and associated duties, will not be specifically considered, although they are certainly part of the overall concept of loyalty to be found both in legislation and self-regulation. In many codes of conduct, obligations and covenants on non-competition are dealt with in the section on loyalty or more specifically on conflicts of interest. See, e.g., the new Code of Corporate Governance approved in Germany in February 2002, Government Commission, German Corporate Governance Code (2002).

2 For recent examinations of the U.S and U.K. duties of loyalty and techniques to safeguard them, see, for example, Deborah A. DeMott, *The Figure in the Landscape: A Comparative Sketch of Directors' Self-Interested Transactions*, 62 Law & Contemp. Probs. 243 (1999); *see also* Luca Enriques, Il Conflitto di Interessi Degli Amministratori (2000); Zipora Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 Cal. L. Rev. 393 (2003).

3 *See* Melvin A. Eisenberg, *Self-Interested Transactions in Corporate Law*, 13 J. Corp. L. 997 (1988) (for the U.S.). But see Robert C. Clark, Corporate Law 161-62 (1986). It is important to underline that these transactions should take place only where there is reciprocal benefit. This occurs only when the object of the transaction is unique or the rent that can be extracted is very high given the particular nature of the parties, as, for example, when they have been business partners for a long time. For standardized transactions, a flat prohibition may be easier to administer. As we will see, this is one of the reasons why many systems prohibit companies

participation of banks and other financial institutions have expanded the range and multiplied the likelihood of conflicts of interest.

The increasing role of criminal liability for disloyal behavior, at both individual and organizational levels, has also contributed to modifying the function of loyalty in corporate governance systems.[4] Within this framework, the strategic oversight role of the board has been emphasized, especially in relation to monitoring management's performance and integrity.[5]

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from lending to directors, since lending is a fairly standardized type of transaction. The problem is how clear a line there is between standardized transactions and non-standardized ones. In theory, if the commodity exchanged is available in the marketplace, it is difficult, on the one hand, to identify what specific advantage the organization may have to buy it from or sell it to one of its members, while on the other hand, if there is a market price, it is easy to detect disloyal behavior if the price diverges. But unfairness may not be related only to price, but also to other terms of the transaction, which may not be so easily comparable.

4 For instance, the role of compliance programs in the U.S, and Italy.

5 *See, e.g.*, OECD, Principles of Corporate Governance § VI (2004) (the responsibilities of the board) [hereinafter OECD Principles]:

> Together with guiding corporate strategy the board is chiefly responsible for monitoring managerial performance and achieving an adequate return for shareholders while preventing conflict of interest and balancing competing demands on the corporation. In order for boards to effectively fulfill their responsibilities they must be able to exercise objective and independent judgment. Another important board responsibility is to oversee systems designed to ensure that the corporation obeys applicable laws, including tax competition, labour, environmental, equal opportunity, health and safety laws. In some countries companies have found it useful to explicitly articulate the responsibilities that the board assumes and those for which management is accountable.

See also the Draft Commission recommendation of July 23, 2004, on strengthening the role of non-executive or supervisory directors:

> [M]aking sure that the management function will be submitted to an effective and sufficiently independent oversight function requires the presence on the (supervisory) board of a sufficient number of committed non-executive or supervisory directors, who, in addition to not performing management duties in the company or its group, are independent, i.e., free from any material conflict of interest ... . The oversight role of non-executive or supervisory directors is commonly perceived as crucial in three areas, where the potential for conflict of interest of management is particularly high, especially when such matters are not a direct responsibility for shareholders: a) nomination of directors ... b) remuneration of directors ... c) audit, which covers both the way in which performance of management is accounted for and reported and the way in which the internal control procedures are established and implemented.

Draft Commission Recommendation on Strengthening the Role of Non-Executive or Supervisory Directors at arts. 12, 13 (2004) [hereinafter Draft Commission]. *See also* NYSE Corp. Accountability Rep. (2002).

Recent events worldwide, however, have highlighted the need for the overall organization not to focus exclusively on the functioning of the board to preserve organizational loyalty for at least two reasons:

1) Often the violations of duties of loyalty have also involved senior managers and employees below board level, affecting multiple organizational layers and showing that hierarchical control had not been effective.[6]

2) The loyalty of an organization depends on the balance between internal and external monitoring, i.e., how well the "gatekeepers" operate in relation to internal monitors, auditors, and controllers.[7]

The first point suggests that to consider an organization as a separate and

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6 The Corporate Monitor Report stated that some 100 people were implicated in the WorldCom scandal. *See* Richard C. Breeded, Restoring Trust, Report to the Hon. Judge Jed. S. Rakoff, on Corporate Governance for the Future of MCI, Inc. 12 (2003) [hereinafter Restoring Trust]. This report was not a mere study but an agreement between the parties in the *SEC v. WorldCom* controversy, and the so-called permanent injunction should prevent similar violations from occurring in the new company, MCI. The recommendations thus defined should provide guidelines for improved corporate governance in MCI.

7 The two monitoring systems are interacting and, though complementary, should not be treated as separate. Recent law reforms such as the Sarbanes-Oxley Act, 116 Stat. 745 (2002), and the Loi sur la securité financiere, Law No. 2003-706 of Aug. 1, 2003, J.O. Aug. 2, 2003, at 13220, in France, have reshaped this relationship. Some monitoring functions are externalized to professionals who are supervised by oversight bodies whose nature can be public, private, or mixed.

From a comparative perspective the combination between internal and external monitoring of management is different. Internal monitoring tends to be higher in European continental system, while it decreases in the U.S. For a comparative assessment, see Edwards S. Adams, *Corporate Governance After Enron and Global Crossing: Comparative Lessons for Cross-National Improvements*, 78 Ind. L.J. 723 (2003). For a broader perspective, see Henry Hansmann & Reinier H. Kraakman, *Agency Problems and Legal Strategies*, *in* The Anatomy of Corporate Law 21 (Reinier H. Kraakman et al. eds., 2004) [hereinafter Hansmann & Kraakman, *Agency Problems*]; Henry Hansmann & Reinier H. Kraakman, *The Basic Governance Structure*, *in* The Anatomy of Corporate Law, *supra*, at 33 [hereinafter Hansmann & Kraakman, *Basic Governance*]. Recent perspectives define trade-offs between different monitoring actors and attached legal regimes by looking at the relationship between objectivity and proximity. *See* Arnoud W.A. Boot & Jonathan R. Macey, *Monitoring Corporate Performance: The Role of Objectivity, Proximity and Adaptability in Corporate Governance*, 89 Cornell L. Rev. 356 (2004); Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure and Enron*, 89 Cornell L. Rev. 394 (2004). For other approaches that underline different types of complementarities, see John C. Coffee Jr., *Gatekeeper Failure: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. Rev. 301 (2004).

independent set of layers, each responsible to its own set of standards, as many legal systems still do, and to divide the matter into corporate and labor law issues does not allow for consideration of the (unlawful) interaction among connected actors located at different points on the organizational chain. Often this fragmented and uncoordinated framework makes violations possible and deterrence ineffectual. But even when the different layers are contextually considered, they are framed in a hierarchical setting and organized within an agency scheme that does not conform to the most recent evolution of power distribution within and among firms.

In order to prevent unlawful behavior, reasonably homogeneous or at least coordinated rules must be drawn up and applied to the entire organizational cha[8]in. For that matter, in order to reduce inefficiencies, a strategic, unifying role has been played by the development of criminal organizational liability.[9]

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8 This is true both when loyalty and conflict of interest rules are aimed at protecting shareholders' interests and when they are defined in the interest of clients. A good example for the need for a regime on conflicts of interest over the whole vertical chain is seen in investment firms. *See* European Parliament & Council Directive 2004/39/EC of 21 April 2004 on Markets in Financial Instruments Amending Council Directives 85/611/EEC and 93/6/EEC; Directive 2000/12/EC of the European Parliament and of the Council and Repealing Council Directive 93/22/EEC, 2004 O.J. (L 145) 1 [hereinafter ISD 2]:

> Member States shall require investment firms to take all reasonable steps to identify conflicts of interest between themselves including their managers and employees and tied agents, or any person directly or indirectly linked to them by control and their clients or between one client and another that arise in the course of providing any investment and ancillary services or combination thereof.

Id. art. 18.1. Certainly these are particular firms that require a special regulatory framework. Yet the scheme developed for this firm may serve to illustrate the general approach taken in the paper about the relationship between standards and organizational design, although the solutions are not always the optimal ones. See also in the Corporate Monitor Report analysis of employment standards and practices translated into Recommendation 10.05:

> One of the Company's major ethical obligations is to adhere to all legal standards relating to employment practices. Beyond legal obligations however, the importance of diversity in the workplace and in the senior management of the company is difficult to understate. While not thought of as a traditional concern of "corporate governance" the issues relating to diversity are part of what should be considered "good governance". A company cannot be thought to be well governed if its internal practices for excellence and priority are set for other areas of governance. Indeed since diversity is an essential part of who is being governed, it should not be seen as something that can be overlooked when creating a structure of excellence in governance.

Restoring Trust, *supra* note 6, at 146.

9 The Italian experience is quite remarkable from this standpoint. See Legislative

Analogous and coordinated reforms should occur in the field of civil liability regarding disloyal behavior, by integrating standards of loyalty along the organizational chain and within governance mechanisms.

The second point underscores the necessity of considering and redefining the balance between internal and external control mechanisms of disloyal behavior in firms. A third crucial element is related to the composition of the board and the search for independence as an accountability-enhancing device. The scandals show that independent board members not directly involved in day-to-day operations were unable to control and detect violations as they emerged. Efforts to create greater board independence, which have been the subject of recent scholarly debate as well as corporate policymaking, should be welcomed. However, they are insufficient to ensure that fiduciary duties of loyalty are not violated. Well-defined independence is a necessary, yet insufficient condition for promoting loyalty.[10] Appropriate law reforms should soon occur in this area to connect the governance devices, such as independent committees or reinforcement of the supervisory board in dual models and internal control protocols and committees with a re-conceptualization of standards of loyalty and remedies that maintain discretionary power while increasing accountability.

This paper makes the following two main claims:

1) The legal dimension of loyalty within organizations goes beyond duties. The governance design aimed at ensuring loyalty may strongly affect standards that characterize each layer of the organization. The interaction between standards of duty and the governance dimension of loyalty should, therefore, be more tailored to specific legal forms and their functional correlation with ownership and financing.

Decree No. 231/2001, June 8, 2001, Gazz. Uff. June 19, 2001, the codes of conduct enacted to define organizational models that would enable avoiding liability under articles 6 and 7.

10 *See* Modernizing Company Law and Enhancing Corporate Governance in the European Union — A Plan to Move Forward, Communication from the Commission to the Council and European Parliament, COM(03)284 final [hereinafter Modernizing Corporate Law]. In the Communication, the Commission states that decisions on corporate policies in areas where conflicts of interest may arise should be taken by independent directors. In order to define a common set of principles on independence, a recommendation will be issued shortly. This recommendation should define the minimum requirements for formation and remuneration of audit and remuneration committees. *See id.* at 16-17. See also the Opinion adopted by the European Parliament on the Action Plan in its plenary meeting on April 21, 2004, when the Parliament called on the Commission to promote rules to eliminate and prevent conflicts of interest.

2) There is a greater divergence than has so far been acknowledged between the function of loyalty in vertically integrated firms and in networks of small firms. This difference, created by the relationship between the duty and the governance dimensions, should have repercussions on the definitions of legal standards. In particular, it should reflect the different relationships between hierarchy, monitoring, and loyalty and the choice between prohibitory, authorization-based, and compensatory rules.

The analysis will concentrate on the key variables that may affect the choice between vertical and horizontal monitoring to ensure compliance with loyal behavior in two polar models: hierarchical firms and networks of small firms.[11] Of course, reality is much more differentiated and nuanced, but to show the need for a new integrated approach, it will be useful to identify the two basic structures. This analysis also will reveal the importance of considering the governance design when defining duties of loyalty and related standards to evaluate party-related transactions in both cases but, at the same time, the necessity of using different interpretive categories.[12]

The paper proceeds as follows: Section II classifies the rules governing duties of loyalty and conflicts of interest. Section III analyzes the role of governance in protecting loyalty and its interaction with duties of loyalty. Section IV identifies the different geometrical dimensions of organizational loyalty by distinguishing between horizontal and vertical monitoring of loyal behavior. It describes the influence that different organizational loyalty chains should have on the choice of rules governing loyalty, particularly between prohibitory rules, on the one hand, and compensatory rules, on the other. Section V advocates a new integrated approach to loyalty in large public corporations, combining the duty and governance dimensions in a framework that takes into consideration the whole organization and does not stop at the board level due to different features of power in the contemporary firm. Section VI poses the problem of loyalty in the context of networks of small firms and explains why the approach currently used and that proposed in the paper for vertically integrated firms are inappropriate for

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11 Protection of organizational loyalty has increasingly become a matter of public concern due to the interdependencies among organizations and the particular relationship between loyalty and trust.

12 The example of the federal sentencing guidelines in the U.S. is revealing about the function of a compliance system and self-reporting. The guidelines give credits to an organization for the existence of a compliance procedure. When a violation occurs, among the mitigating factors, cooperation and self-reporting are highly considered. In particular, cooperation with regulatory and enforcement bodies is considered to be an important mitigating factor.

networks. It then analyzes the relevant dimensions of loyalty and suggests that an external dimension be added to the internal one. Loyalty protects inter-organizational trust together with intra-organizational trust. The paper ends with concluding remarks.

II. THE CHANGING DIMENSIONS OF RULES GOVERNING DUTIES OF LOYALTY AND CONFLICTS OF INTEREST

The issue of loyalty has generally been treated as a matter of duties. The rules governing conflicts of interest can be taken as a sub-genre of those governing loyalty. The members of the organization, in their individual capacities as directors, employees, shareholders, and/or members have a duty of loyalty towards the organization and may have additional duties towards the members or a class of members within the organization.[13] Duties of loyalty may also be owed by the organization towards its members. Finally, duties of loyalty may be directed towards third parties such as stakeholders, who are not legally part of the organization, but nonetheless are owed duties of loyalty or fair dealings. Another example would be creditors and suppliers who may have as great an interest as shareholders in protecting internal organizational loyalty and the firm's assets from misappropriation. Legal systems often recognize this interest and protect it either through corporate, contract, tort, or bankruptcy law.[14] (Throughout this paper I assume a clear distinction between owners and creditors, but given the multiplicity of financial instruments that exist, this distinction is blurry and a more integrated approach to organizational loyalty, which is beyond the scope of this paper, may be required.)

Such duties of loyalty generally regard specific acts, contracts or activities. The different directions that these duties flow in demonstrate that the loyalty is reciprocal, or at least multilateral more than hierarchical, and cannot be

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13 For example, majority shareholders' duty of loyalty towards minority ones as distinct from that of the directors. The importance of minority protection in relation to loyalty and conflicts of interest should be viewed from two different perspectives. The conflict of interest is frequently not between directors and shareholders, but between directors and shareholders, on the one side, and minority shareholders, on the other. This focus on minority shareholders is peculiar to corporate law and may require a different approach from that regarding minority protection within partnerships and joint ventures.

14 Duties of loyalty are owed to creditors to different degrees in legal systems. They tend to become stronger in the proximity of insolvency. For a recent comparative account, see Gerard Hertig & Heideki Kanda, *Creditor Protection*, *in* The Anatomy of Corporate Law, *supra* note 7, at 71, 88-89.

entirely captured by the agency approach, which presupposes agents who have to act loyally on behalf of principals. Rules that are relevant to the breach of the duty of loyalty can, on a very general, abstract level, be classified as prohibitory, authorization-based or compensatory.[15]

1. Prohibitory Rules: A first set of rules defines prohibitions as acts or transactions that may not be made within the organization or between organizations or between the organization and individuals. These prohibitions may allow the transaction to take place only in specific, exceptional circumstances.[16] Prohibitions may be generalized or else directed

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15 For an earlier attempt to classify conflict of interest rules in a comparative perspective based on the remedial structure, see Luca Enriques, *The Law on Corporate Directors' Self-Dealing: A Comparative Analysis*, 2 Int'l & Comp. Corp. L.J. 297 (2000). *See also* Enriques, *supra* note 2; Goshen, *supra* note 2 (for a more recent analysis).

16 *See* Sarbanes-Oxley Act, *supra* note 7, § 402 (a) (enhanced conflict of interest provisions):

> 1. It shall be unlawful for any issuer ... directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer. An extension of credit maintained by the issuer on the date of enactment of this subsection shall not be subject to the provisions of this subsection, provided that there is no material modification to any term of any such extension of credit or any renewal of any such extension of credit on or after that date of enactment. 2. Paragraph (1) does not preclude any home improvement and manufactured home loans ... consumer credit ... or any extension of credit under an open end credit plan ... or a charge card ... or any extension of credit by a broker or dealer registered under section 15 of this title to an employee of that broker or dealer to buy, trade, or carry securities, that is permitted under rules or regulations of the Board of Governors of the Federal Reserve System pursuant to section 7 of this title (other than an extension of credit that would be used to purchase the stock of that issuer), that is (A) made or provided in the ordinary course of the consumer credit business of such issuer; (B) of a type that is generally made available by such issuer to the public; and (C) made by such issuer on market terms, or terms that are no more favourable than those offered by the issuer to the general public for such extensions of credit.

See article 225-43 of the French Code de Commerce:

> A peine de nullité du contrat, il est interdit aux administrateurs autres que les personnes morales de contracter, sous quelque forme que ce soit, des emprunts auprés de la société, de se faire consentir par elle un découvert, en compte courant ou autrement, ainsi que de faire cautionner ou aviser par elle leurs engagements envers les tiers.

See article 2475 of the Italian civil code introduced in 2003, which regulates conflicts of interest in SRL:

> I contratti conclusi dagli amministratori che hanno rappresentanza della società in conflitto di interessi per conto proprio o di terzi, con la medesima possono essere

at specific members of an organization or type of transaction.[17] Transactions in the face of prohibitions are generally void or voidable, and liability for having engaged in void or voidable transactions ensues. In such a case, validity and liability rules are often coupled. Prohibitions may derive from law, charters, bylaws, or codes of conduct. These rules are generally characterized by a low level of discretion on the part of the organization and of the internal or external bodies who have to monitor their compliance.

2. Authorization-Based Rules: A different approach to the duty of loyalty, in general, and to conflicts of interest, in particular, is to permit transactions to proceed on condition that their definition be subject to authorizing approval.[18] In this case, the interested party is generally exempt from liability even though it later emerges that a conflict of interest existed. When the transaction is concluded, without the approval or with a procedurally defective approval, sanctions differ, ranging from nullity to compensation or to a combination

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annullati su domanda della società, se il conflitto era conosciuto o riconoscibile dal terzo.

Le decisioni adottate dal consiglio di amministrazione con il voto determinante di un amministratore in conflitto di interessi con la società, qualora le cagionino un danno patrimoniale, possono essere impugnate entro novanta giorni dagli amministratori e, ove esistenti, dai soggetti previsti dall'art. 2477. in ogni caso sono salvi i diritti acquistati in buona fede dai terzi in base ad atti compiuti in esecuzione della decisione.

Codicie Civile [C.c.] art. 2475 (Italy).

17 Transactions forbidden to directors may be different from those for managers and employees.

18 Technically there are very different solutions within this family of rules. We go from systems in which an explicit and well-motivated authorization is needed to systems in which the board is obliged to provide a thorough motivation concerning the advantages of the specific transaction or operation. In the latter, even if there is not explicit approval, the duty to provide adequate motivation can be seen as functionally equivalent. See, for example, article 2391 of the Italian Civil Code, reformed in 2003, which states:

L'amministratore deve dare notizia agli altri amministratori ed al collegio sindacale di ogni interesse che, per conto proprio o di terzi, abbia in una determinata operazione della societá, precisandone la natura , i termini, l'origine e la portata; se si tratta di amministratore delegato, deve altresí astenersi dal compiere l'operazione investendo della stessa l'organo collegiale. Nei casi previsti dal precedente comma la deliberazione del consiglio di amministrazione deve adeguatamente motivare le ragioni e la convenienza per la società dell'operazione.

of the two.[19] The differences may also affect the rights of third parties.[20] These rules may concern: 1) procedural aspects regarding internal decision-making;[21] or

2) substantive aspects balancing costs and benefits of a specific transaction for the company, in particular the existence or non-existence of a test against which final approval or rejection is to be made.

A radical difference exists between rules requiring unanimous approval and those requiring approval by the majority (either in the pure form or as a majority of the minority) of the board.[22] A further difference is related to approval procedures concerning the potentially disloyal transaction. Many are fully discretional. Responsible parties do not have to follow a predefined test, and courts are not able to rule on the merits of final decisions. This is particularly problematic when the competent body acts as an agent for other principals, as happens, for example, when a board of directors approves a transaction serving the interests of shareholders. Sometimes discretion is limited by a duty to motivate why the transaction has been approved or

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19 Nullification plays a greater role in the UK, whereas the damages remedy appears to be favored in the United States. France and Japan walk a middle road by favoring nullification when conflicted transactions lack board authorization but preferring a damages remedy when board authorization of a conflicted transaction is defective — for example, in French SA, because shareholders have not ratified it.

Gerard Hertig & Hideki Kanda, *Related Party Transactions*, *in* The Anatomy of Corporate Law, *supra* note 7, at 101, 108. *See* Code de Commerce [C. Com.] art. 225-41 (Fr.): "Sans préjudice de l'intéressé, les conventions visées à l'article L. 225-38 et conclues sans autorisation préalable du conseil d'administration peuvent etre annulées si elles ont eu des cons?quences dommageables pour la société."

20 *See, e.g.*, Code de Commerece [C. Com.] art. 225-41 (Fr.).

Les conventions approuvées par l'assemblée, comme celles qu'elle désapprouve, produisent leurs effets à l'égard des tiers, sauf lorsqu'elles sont annulées dans le cas de fraude.

Meme en l'absence de fraude, les conséquences, préjudiciables ˚ la sociétè, des conventions désapprouvées peuvent etre mises à la charge de l'intéressé et, éventuellement des autres membres du conseil d'administration.

21 Legal systems differ. Some require shareholder approval (France); some distinguish among transactions for which mandatory shareholder approval is required and those for which it is not (U.K.); others require board approval or the appointment of a special committee (U.S., Japan, and Germany). *See* Hertig & Kanda, *supra* note 19, at 109.

22 In both cases, parties are given full power to decide whether the transaction complies with the principle of loyalty. In one case, each voter is given the power to veto opportunistic conduct. In the other, if the majority is not well-defined, minorities may suffer harm.

rejected. The competent body can determine the criteria and express its own judgment, but it has to provide full motivation. Other procedures require that the competent body be constrained by some criteria defined *ex ante* either by outside rules or by the body itself.

The differences between these rules and prohibitory rules are far-reaching, even regarding unanimous approval. Prohibitory rules provide limited freedom for the organization to contract, either because of the high danger of externalities or because it would be so costly to obtain interested parties' consent that the potential benefits of a self-interested transaction would be lost. In the case of unanimous consent, parties have the final decision-making power. The costs of a unanimous consent rule are such that the choice of legal system will favor either prohibitory rules or majority consent.[23]

3. Compensatory Rules: Compensatory rules are those that entitle wronged parties to be compensated when violation of the duty of loyalty has occurred and/or when a conflict of interest in a self-dealing transaction has taken place. These are liability rules that, unlike the case of prohibitory rules, are not associated with invalidity of the contract or the act.[24] The function of damages differs between the two rules. While with regard to prohibitory rules, damages primarily play a role of deterrence, with compensatory rules damages operate as a compensatory device.

Compensatory rules, therefore, differ from prohibitory ones in that their only sanction is compensation while the causative transaction is left standing. They differ from authorization-based rules in that their capacity to define acceptable conduct or to conclude a transaction is independent of the consent previously provided.

Loyalty rules are, by and large, a combination of rules from different sources, which have evolved over the past forty years from prohibition to authorization and, recently, to compensation.[25] There are signs that the

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23 There is a significant difference between rules that prohibit a transaction and those that require consent, whether unanimous or not. A prohibitory rule is a substantive limitation on an organization's freedom to contract and removes the power of decision for authorizing a transaction. A rule that allows a transaction, even though it requires unanimous consent, allocates the power of decision to the organization members (be it the board or the shareholders meeting). Hence my decision to introduce a third, prohibitory rule, which I set within the same category as approval by unanimity and approval by a majority of the minority, while still acknowledging the radical difference between the two rules, both in terms of negotiation starting points and efficiency/distributional effects.

24 As I have already mentioned, a void transaction to which some type of liability is attached is a prohibitory rule. A valid transaction that violates duty of loyalty to which some type of liability is associated is a compensatory rule.

25 For a description of these changes in the U.S. legal system, see Harold Marsh, *Are*

pendulum may be swinging back to a perception of prohibitory rules as less discretionary and easier to administer, therefore increasing, so goes the claim, the accountability of the company.[26] These changes can also be described as shifting from rules to standards.[27]

Changes of rules have transformed the scope of liability for disloyal behavior. A parallel trend is that of expanding the scope of liability for failure to control compliance with loyalty standards, both by corporate committees and by auditors or other gatekeepers.[28] This evolution towards prohibitory rules, representing a reaction caused by the inability to govern the risk of self-dealing transactions and more general disloyal behavior, may bring about higher organizational rigidity without increasing the level of loyalty and accountability.[29]

Changes of rules are often associated with changes in the institutional

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Directors Trustees? Conflict of Interest and Corporate Morality, 22 Bus. Law. 35 (1966); Eisenberg, *supra* note 3. For a more recent comparative perspective, see Enriques, *supra* note 15; Edward Rock & Michael Wachter, *Dangerous Liaisons: Corporate Law, Trust Law and Interdoctrinal Legal Transplants*, 96 Nw. U. L. Rev. 651 (2002); Goshen, *supra* note 2; Hertig & Kanda, *supra* note 19, at 101 *passim*; Coffee, *supra* note 7, at 334-35.

26 For example, rules prohibiting companies from lending to their executives. *See* Sarbanes-Oxley Act, *supra* note 7, § 402 (for the U.S.).

27 *See* Hansmann & Kraakman, *Agency Problems*, *supra* note 7, at 24. Hansmann & Kraakman point out that in the area of self-dealing there can be both rules operating *ex ante* and standards operating *ex post*: "a rule may prohibit a class of self-dealing transactions outright, while a standard might mandate that these transactions will be judged against a norm of fairness ex post." *Id.* at 27.

28 An increasing role of internal discretion and power to define standards not supported by a corresponding stricter liability has been partially compensated for by enlarging the numbers of external monitors and by strengthening their liability. In relation to the U.S., see Coffee, *supra* note 7. The author identifies signs of an increased scope of liability for issuers and gatekeepers due also to changes concerning accounting principles. His claim is that a move from a rule-based system as that of GAAP (generally accepted accounting principles) to a more principle-based system, close to the European style, would increase litigation in the United States.

29 The danger of excessive rigidity associated to the need of increasing accountability is clear in the evolution of U.S. corporate governance concerning listed companies where the activities of independent committees are now centrally regulated, imposing definitions of what to do and to some extent how it will be done. Certainly this might increase transparency, but it can also create procedural rigidity that would not ensure the achievements of desired outcome. For criticism of such an approach, see William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. Pa. L. Rev. 953 (2003).

environment. Proposals for law reform calling for a stricter approach based on prohibitory rules are often associated with a quest for a decrease in self-regulation and stronger public regulation. And they also affect power distribution among different actors. While prohibitory rules are predominantly mandatory and administered by judges, the standards associated with authorization-based rules and compensatory rules, though quite different, are defined internally on the basis of general legal principles and left predominantly to self-enforcement. In fact, there is also often an internal system of monitoring and sanctioning that operates prior to or as an alternative to judicial intervention.

Proposed law reforms are also aimed at affecting external monitoring. They design a shift from professional self-regulation to co-regulation in relation to the role of different gatekeepers, accountants, rating agencies, financial analysts, and lawyers. It is unclear, however, whether in the end these reforms will decrease the role of the judiciary or whether they will simply modify it.

Information rules, particularly disclosure, concerning organizational loyalty deserve special attention. The role of information, in general, and of duties to inform and disclose, in particular, is highly pertinent in the promotion and guaranteeing of organizational loyalty. Here, the interaction between securities regulation and corporate governance is particularly relevant since many disclosure requirements are defined by securities law but severely affect corporate governance.[30] This relationship also explains the expanding role of external loyalty's guardians. Recent law reforms have expanded the role of information and have proceduralized the flux by imposing duties to inform on board members and committees.[31] The system of organizational loyalty is strongly affected by such law reforms in terms of both standards and governance design. They are aimed at improving both the information flow towards the market and the internal flows between shareholders and boards and within the board committees.[32] The rules requiring disclosure of party-related transactions may have independent

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30 On the interaction between regulatory and governance strategies in corporate law, see Hansmann & Kraakman, *Agency Problems*, *supra* note 7, at 21.

31 See on this point, for example, the Italian law reform of corporate law from 2003-2004, particularly the Civil Code, Codicie Civilie [C.c.] art. 2381 (Italy); for the U.S., see the Sarbanes-Oxley Act, *supra* note 7.

32 While the use of committees may improve the work of the board they may also raise questions about the collective responsibility of the board and of individual board members. In order to evaluate the merits of the board committees it is therefore important that the market receives a full and clear picture of their the increasing number of jurisdictions where boards are establishing independent

justifications, or may be instrumental in complying with one of the standards associated with prohibitory, authorization, or compensatory rules.[33] The functions of the duties to inform change substantially, however, if the final goal is to ensure compliance with prohibitory rules or to permit approval of acts or transactions by the competent body or if it is associated with compensatory rules.[34]

In relation to prohibitory rules, mandatory disclosure has a complementary

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audit committees with powers to oversee the relationship with external auditors and to act in many cases independently ... . Disclosure should not extend to committees set up to deal with for example, confidential commercial transactions.

OECD Principles, *supra* note 5, § VI ¶ E.2. See also the Draft Recommendation of the European Commission, article 9, on Transparency and Communication:

1. The (supervisory) board should make available to the public at least once a year (as part of the information disclosed by the company annually on its corporate governance structures and practices) adequate information about its internal organisation and procedures applicable to its activities. 2. The (supervisory) board has a special duty to ensure that shareholders are properly informed on the affairs of the company, its strategic approach and on how risks of conflicts of interest are managed. The roles of directors regarding communication and engagement with shareholders should be clearly designated.

Draft Commission, *supra* note 5, art. 9.

33 *See, e.g.*, Code de Commerce [C. Com.] art. 225-39 (Fr.):

Les dispositions de l'article L. 225-38 ne sont pas applicable aux conventions portant sur des opérations courantes et conclues à des conditions normales. Cependant, ces conventions, sauf lorsqu'en raison de leur objet ou de leurs implications financiéres, elle ne sont significatives pour aucune des parties, sont communiquées par l'intéressé au président du conseil d'administration. La liste et l'objet desdites conventions sont communiquées par le président aux membres du conseil d'administration et aux commissaires aux comptes.

The following article is associated with an authorization based rule: "L'intéressé est tenu d'informer le conseil, dès qu'il a un connaissance d'une convention à laquelle l'article L. 225-38 est applicable. Il ne peut prendre part au vote sur l'autorisation solicitée." *Id.* art. 225-40.

34 Information flows both within the organization and between the organization and the external world are quite problematic. Firms oblige officers and managers and often employees to sign confidentiality agreements or declare acceptance of the firm's general policies. These agreements and declarations create entitlements, generally in the form of quasi property rights on information regarding the firm. They are aimed not only at preventing unfair competition but also at demanding loyalty through prescribing an obligation not to reveal corporate misconduct to third parties or even within the organization to other internal divisions. Such agreements have posed serious problems in the cooperation with regulatory supervisory bodies and judicial authorities. Recent scandals have highlighted the need to limit this process of propertization of organizational information concerning (dis)loyal behavior, but confidentiality agreements and their capacity to curtail information are still considered legitimate in many legal systems. Even if the main purpose of

function. Since only a limited number of transactions can be prohibited, prohibitory rules are generally associated with disclosure rules concerning permitted transactions.

In relation to authorization-based rules, disclosure is instrumental. The duty to inform on interested parties is functional to an appropriate evaluation of the costs and benefits of the related party transaction.

The choice among the three different categories of rules may be made according to several parameters, but each implies a different degree of discretion. I would like to focus particularly on the monitoring costs concerning compliance with the rules.

Part of determining which rule is most suitable involves assessing the monitoring costs of each in terms of determining the standard and verifying compliance.[35] Once the standards are defined, the organization sets a monitoring mechanism in place to detect violations. While these mechanisms do not seem to vary in accordance with the type of rules adopted, it is reasonable to believe that the monitoring of a standard, which results in a compensatory remedy in the case of a violation, would require different investments and administrative arrangements than those required with respect to standards associated with a prohibitory rule or an authorization — based rule.[36]

Knowing *ex ante* the costs involved in monitoring these rules may be quite difficult. This uncertainty may, in turn, affect the choice of the optimal set of rules in relation to the governance device needed to administer them.[37] Monitoring has more than one geometrical dimension, including monitoring by board members and shareholders and vertical monitoring by directors and managers towards employees. I will now examine the costs of monitoring the board and will postpone considering vertical monitoring until the analysis of the vertical dimension of loyalty generally associated with the duty of care.

Each rule involves some costs in monitoring its compliance, over and

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confidentiality agreements is to avoid information leaking outside the organization, they may be used to prevent information flow concerning internal misconduct.

35 Rules have different costs and monitoring is only one of them. For example, the use of prohibitory rules may be more costly than compensatory rules for the parties who have to comply with them. I will focus on monitoring costs because it is the element most relevant to producing overall organizational loyalty.

36 A clear relationship between conflict of interest and organizational arrangements has emerged with respect to investment firms. *See* Parliament & Council Directive 2004/39 arts. 13, 18.

37 The definition of an appropriate governance mechanism should be directed at designing a trust-enhancing structure more than a pure cost-minimizing procedure when the two goals do not converge.

above adjudication costs. Monitoring costs increase when incentives among different corporate actors are strongly misaligned. Prohibitory rules are the cheapest to monitor because when the prohibition is specific, it is relatively easy to identify the forbidden transaction or conduct since it does not generally require a complex procedure or a specially appointed competent body to evaluate its fairness. Authorization-based rules are quite expensive to administer. Their monitoring costs depend on what conditions are associated with the authorized act and what procedures are to be followed. Of the three types of rules, they are certainly the most expensive. Compensatory rules require relatively low monitoring and accompanying costs to identify whether a violation has taken place. They may either be self-enforced through an internal body or require judicial adjudication. The costs of monitoring increase when the injured parties have relatively low access to information, as might be the case for minority shareholders, who would have difficulty detecting the violation.

III. REFRAMING LOYALTY: FROM FIDUCIARY DUTIES TO AN INTEGRATED GOVERNANCE DESIGN?

The shift from prohibitory to authorization-based and compensatory rules in relation to duties of loyalty has been due to the increased need for organizational discretion when deciding what type of acts or transactions could qualify as self-dealing. The rules concerning duties of loyalty and self-dealing are considered mandatory in many legal systems, but the internal balance between standards determined by the law and standards determined by corporate actors, in particular the board of directors, has shifted in favor of the latter.

The standard-setting activity has been regulated mainly by internal rules and protocols, but also by the use of codes of conduct or guidelines, often associated with compliance programs related to corporate crimes.[38] In some

38 See, for example, the Italian experience with Legislative Decree No. 231/2001 from June 8, 2001, Gazz. Uff. June 19, 2001. It should be noted that these are two different yet related dimensions. Traditional duties of loyalty are generally established to protect companies and shareholders from disloyal conduct of corporate actors. In these cases the breach of the duty of loyalty is always detrimental. In other words the detriment or harm to the organization is a precondition for the breach. Codes of conduct, related to the commission of corporate crimes, regulate conduct of corporate actors, directors, managers, and employees that can be also undertaken in the interest of the corporation. Therefore, when it comes to the organizational models defined by companies to escape liability as is the case under articles 6 of the Italian

cases, the adoption of codes of conduct, defining adequate organizational models, permits the exclusion or reduction of criminal corporate liability.[39]

The role of self-regulation at the individual firm level and the industry level has grown recently, in relation to both civil and criminal liability related to loyalty issues, although these developments were under severe scrutiny in the past.[40] A distinction should, however, be made between the use of self-regulation in relation to professionals operating as monitors of organizational

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decree 231/2001, the aim is mainly to protect the public interest even at the expense of the company's interests. This partial divergence prevents consideration within a unitary structure of organizational models aimed at preserving organizational loyalty in the interest of the company and models aimed at preventing corporate actors from committing corporate crimes that would imply criminal or administrative liability of the company. Such a divergence should not prevent a comprehensive consideration of organizational models directed at controlling the unlawful conducts of corporate actors.

39 See, for Italy, articles 6 and 7 of Decree 231/2001, excluding or reducing liability of the company when a code of conduct defining an appropriate organizational model has been put in place and adequately implemented.

40 Despite criticisms, codes of conduct constitute a relevant part of the U.S. reform. In relation to listed companies, both the NYSE and the NASDAQ require adoption and disclosure of codes of business conduct. Companies have to adopt corporate governance guidelines that define management's succession, director responsibilities, and other topics. *See* NYSE, Listed Company Manual arts. 303A.09, 303A.10, available *at* http://www.nyse.com/Frameset.html?displayPage=/listed/1022221393251.html, and comments concerning the topics that must be addressed by the code. The most important change has involved the new relationships between self-regulation and public regulation: from a pure or delegated self-regulation strategy to co-regulation. In relation to the auditing profession, after the financial scandals, the Sarbanes-Oxley Act, *supra* note 7, created a new body, the Public Company Accounting Oversight Board PCAOB, to regulate the profession, set standards, and impose sanctions.
In France, the tasks of the Haut Conseil du commisariat aux comptes are defined as follows:

> Assurer la surveillance de la profession avec le concours de la Compagnie nationales des commisaires aux comptes instituée part l'article L.821-6;
>
> Veiller au respect de la dèontolgie et de l'indépendence des commissaires aux comptes. Pour l'accomplissement de cette mission, le Haut Conseil du commissariat aux comptes est en particulier chargé: d'identifier et de promouvoir les bonnes pratiques professionnelles;
>
> D'émettre un avis sur les normes d'exercice professionnel élaborées par la Compagnie nationale des commissaires aux comptes avant leur homologation par arrete du garde de sceaux, ministre de la justice ... .

Loi sur la securité financiere, *supra* note 7.
La rapport sur la loi financière stated:

> Dans le contexte des scandals financiers qui ont agité Les Etats-Unis, la profession

loyalty or gatekeepers and internal self-regulation, which concerns standards of loyalty of board members, managers, and employees.[41]

The change was not limited to pure rule-making, but once companies took on the burden of defining standards of loyalty, they also realized that an internal governance design should accompany rule-making. The exercise of discretion implied the creation of an internal system of checks and balances to ensure accountability and credibility towards shareholders and creditors, but also towards suppliers and consumers. This is only one component of a broader change concerning a board's liability for the adoption of an adequate organizational model.[42]

A strong correlation between governance design and standards of duties is associated with the changes in the rules described above. In fact, different rules may have different implications for governance design. While a system based on prohibitory rules has a relatively low discretionary level and, to the extent that prohibitions are *ex-ante* well-defined, it only requires a good monitoring and internal sanctioning system, both authorization-based and compensatory rules are based on a more discretionary evaluation

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de commissaire aux comptes est apparue comme un element clef dans la chaine de l'information financière. Pour renforcer la crédibilité de la profession en France aux sobresauts des événements internationaux et en prévention de glissement éventuels, il est opportun de sortir de l'autorégulation pure et de doter les métiers de l'audit d'une instance de surveillance externe et de les soumettre à des règles plus pr?cises. Le projet de loi lui-meme contribue à cet infléchissement. Ainsi, en application de l'article 78 du projet qui complète l'article L. 225-235 du Code de commerce, les commissaires aux comptes présentent un rapport particulier sur les procédures de control interne quand elles sont mises en œuvres par la société pour l'élaboration et le traitement de l'information contable et financière. Pour sortir de l'autorégulation, le projet de loi propose un nouveau cadre d'exercice de la profession, fondé sur un partenariat entre, d'une part, les pouvoir publics incarnés dans un nouvel organe, Le Haut Conseil du commissariat aux comptes, placé auprés du garde des Sceaux, ministre de la Justice, et, d'autre part, la profession représentée par la compagnie nationale des commissaires aux comptes et par les commissions régionales.

For a more general description of the European level in terms of the increasing use of co-regulation in lieu of pure self-regulation in several areas, including corporate governance, see Fabrizio Cafaggi, Le Role des Acteurs Privés Dans le Processus de Retion publique (2004).

41 The use of self-regulation to regulate accountants' activities when they perform monitoring functions has been hotly debated both at national and international levels and has brought about several law reforms moving from self-regulation to forms of co-regulation.

42 Such liability is both civil and criminal. See, e.g., for the Italian system, Decree 231/2001 arts. 6 & 7, and C.c. § 2381.

by the competent bodies for the reasons outlined above and, therefore, are more sensitive to governance design. To be administered, they need specific committees within or outside the board dedicated to the task. These committees might have to perform different functions, from standard-setting to monitoring and even sanctioning, and require particular attention be paid to their composition.[43]

The definition of loyalty standards and ethical behavior has implied the necessity of involving independent actors to decrease the risk of opportunism and to signal lack or reduced level of conflicts of interest between rule-makers and those who are supposed to comply with the rules. The governance design has concentrated on the definition of mechanisms for generating new standards, monitoring their compliance and ensuring detection of violations and sanctioning.

A second related change, which occurred for independent reasons, has affected the structure of organizational loyalty. Vertically integrated firms have modified their internal governance by de-hierarchizing their decision-making procedures.[44] The importance of knowledge-creation mechanisms, involving managers and employees at top levels, coupled with a higher degree of autonomy of lower level personnel when dealing with third parties, has modified the internal hierarchy of firms.[45] In turn, these changes have affected not only the content of the standards of loyalty but also the procedures that define them. These new standards have to reflect the existence of greater autonomy and independence within the organization and, therefore, more direct responsibility of managers and employees towards the organizations and third parties.[46] Thus, the increasing importance of

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43 *See* OECD Principles, *supra* note 5, § VI para. E.1:

> The board may also consider establishing specific committees to consider questions where there is a potential for conflict of interest. These committees may require a minimum number or be composed entirely of non executive members. In some countries, shareholders have direct responsibility for nominating and electing non-executive directors to specialized functions.

44 This has occurred at least in two different ways: first by using more participatory procedures; second by allocating the decision-making power between different points of the organization due also to the increased role of knowledge as a critical resource.

45 *See* Raghuram G. Rajan & Luigi Zingales, Saving Capitalists From Capitalists 68 *passim* (2003); Raghuram G. Rajan & Julie Wulf, The Flattening Firm (2002); Luigi Zingales, *In Search for New Foundations*, 55 J. Fin. 1623 (2000).

46 An analysis of vicarious liability in relation to issues concerning duties of loyalty owed directly by employees and managers towards third parties is beyond the scope of this article.

governance in designing loyalty-generating mechanisms has evolved towards a search for independence, participation, and transparency, to which I now turn.

IV. ORGANIZATIONAL GOVERNANCE AND LOYALTY: ARE SOME MODELS BETTER SUITED THAN OTHERS FOR PRESERVING AND PROMOTING LOYALTY?

Having reviewed the different rules and the changed features of hierarchy, I now turn to related questions of governance: whether organizational design can preserve or foster loyalty and how it should be related to the choice among the different types of rules. There is growing attention to this problem due, on the one hand, to the weakness of exclusively safeguarding loyalty by using a system based on duties and liabilities administered by judges. On the other hand, a good institutional framework might help prevent conflicts of interest from arising.[47]

Two major developments have occurred: (1) internal proceduralization to favor verifiability and (2) a search for independent actors to ensure impartiality and objectivity. The increasing need for standard-setting concerning loyalty has been one of the causes of change within corporate life, both in procedural and substantive terms. Decision-making in general tends to be more proceduralized as a response to accountability failures.[48] Definition of procedures results in a decrease only of procedural discretion, without reducing substantive discretion. Mere proceduralization, therefore, is not enough, even if it increases verifiability. More frequent interactions with other actors, especially creditors, banks, and financial institutions, have exposed companies to more potential conflicts of interest, which requires a

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47 *See, e.g.*, OECD Principles, *supra* note 5, § VI para. E.1.

> Board should consider assigning a sufficient number of non-executive board members capable of exercising independent judgment to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are ensuring the integrity of financial and non financial reporting, the review of related party transactions, nomination of board members and key executives, and board remuneration.

48 In the U.S., for example, in relation to listed companies, aspects concerning participants at board meetings, in particular presence or absence of management, have been centrally regulated requiring, in certain cases, that management not participate in board meetings.

different institutional response.[49] The answer has been partly a search for independent standard-setters within organizations, partly to externalize this function to private collective regulatory bodies with the goal of pursuing collective legitimacy, and partly to search for co-regulating arrangements that can ensure cooperation between public and private regulators.[50] The general claim is that self-regulation is not appropriate to deal with conflicts of interest and that this inadequacy expands to loyalty in general.[51] Independence relates not only to the board but also to external monitors and controllers. The new regulations for independent auditors, enacted or about to be enacted on both sides of the Atlantic, are clear on the need to combine internal and external

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49 The increasing role of financial institutions in corporate lives has called upon a stronger regulation of conflicts of interest.

50 For a general introduction to cooperative regulatory arrangements and the problems they pose, see Cafaggi, *supra* note 40.

51 The effective functioning of self-regulation of compliance program(s) has been under scrutiny due to recent scandals, and there is a rise in interventions by public and private regulatory bodies to define standards or to place constraints on organizational discretion in the definition of standards. The combination of standard-setting and monitoring may be problematic when the regulators are also regulated and when the latter nominate the former. For this reason, the importance of independent directors has grown, but the question concerning criteria for nomination has been hotly debated. For the French experience, see the Loi sur la securité financiere, *supra* note 7, where the introductory report states:

> Dans le contexte des scandals financiers qui ont agité Les Etats-Unis, la profession de commissaire aux comptes est apparue comme un element clef dans la chaine de l'information financière. Pour renforcer encore la crédibilité de la profession en France aux sobresauts des événements internationaux et en prévention de glissement éventuels, il est opportun de sortir de l'autorégulation pure et de doter les métiers de l'audit d'une instance de surveillance externe et de les soumettre à des règles plus précises. Le projet de loi lui-meme contribue à cet infléchissement. Ainsi, en application de l'article 78 du projet qui complète l'article L. 225-235 du Code de commerce, les commissaires aux comptes présentent un rapport particulier sur les procédures de control interne quand elles sont mises en œuvres par la société pour l'élaboration et le traitement de l'information contable et financière. Pour sortir de l'autorégulation, le projet de loi propose un nouveau cadre d'exercice de la profession, fondé sur un partenariat entre, d'une part, les pouvoir publics incarnés dans un nouvel organe, Le Haut Conseil du commissariat aux comptes, placé auprés du garde des Sceaux, ministre de la Justice, et, d'autre part, la profession représentée par la compagnie nationale des commissaires aux comptes et par les commissions régionales.

independence,[52] otherwise the route to impunity would simply be to outsource monitoring.

The relationship between the standards of the duties of loyalty and a particular organizational form is recognized under various legal systems, and it is generally acknowledged that standards may differ depending on which type is considered. To the extent that legal forms are the expression of specific modes of governance, a link between standards of duties and governance design is therefore established. What is less studied is the function that a specific governance structure may have to promote loyalty — independent from duties of loyalty owed by specific classes to the organization — and the influence that the structure may have on the ways in which duties of loyalty operate within the organization.[53]

The opportunity to link governance analysis to standards of loyalty stems from the need for an organization to define at least:

1. a compliance program concerning loyalty, and in particular self-dealing transactions, independent from, but not unrelated to, those concerning corporate crimes;[54]

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52 See, for the U.S., the Sarbanes-Oxley Act, *supra* note 7, § 201, which forbids public accounting firms from providing the following services contemporaneously with the provision of audit services: bookkeeping and other related services, financial information system design and implementation, appraisal or valuation services, fairness opinions or contribution in kind reports, actuarial services, internal audit services, management of HR functions, broker or dealer, investment adviser or investment banking services, legal and other expert services unrelated to the audit, and any other services that the Public Accounting Oversight Board determines to be impermissible.

53 This aspect is now recognized at a legislative level. *See* ISD 2, *supra* note 8, art. 13.2: "An investment firm shall establish adequate policies and procedures, sufficient to ensure compliance of the firm and its directors, employees and tied agents with its obligations under the provisions of this Directive as well as appropriate rules governing personal transactions by such persons." Article 16.2 of the proposal states: "Member States shall require that investment firms whose activities give rise to conflicts of interest maintain and operate effective organizational and administrative arrangements to prevent those conflicts from adversely affecting the interests of clients, or otherwise manage them so as to achieve the same results." It has been modified with article 13.3, which states the following: "An investment firm shall maintain and operate effective organizational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interests as defined in article 18 from adversely affecting the interests of its clients." *Id.* art. 13.3. And then it is specified under article 13.5.2, "An investment firm shall have sound administrative and accounting procedures, internal control mechanisms, effective procedures for risk assessment, and effective control and safeguard arrangements for information processing systems." *Id.* art. 13.5.2.

54 It is worth restating the difference between compliance programs aimed at preventing

2. a monitoring structure to ensure compliance or detection of violations;
3. a reporting system that allows external scrutiny of the decisions made by the board or the committee; and
4. a system of sanctions that enables the firm to operate as an effective private enforcer.

The shift towards compensatory rules described above, therefore, has mandated the definition of standards and procedures combining discretion and accountability, involving organizational structures and procedures to a larger extent than previously required by prohibitory rules. Furthermore, it might entail a different relationship between internal allocation of decision-making power and external auditors and controllers.[55]

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corporate criminal liability and compliance programs aimed at preserving internal and external organizational loyalty. Having specified such a distinction, it should be mentioned that common organizational features, especially in relation to monitoring, can be put in place and that sometimes the same violations define corporate crimes and disloyal behavior.

It is interesting to note the possible implications for internal organization. Alongside the need to centralize competences in an Ethics Office, incentive and responsibility systems need to be decentralized throughout the organization in order to comply with ethical standards. See, e.g., the proposals concerning MCI in Restoring Trust, *supra* note 6, at 142:

> The Ethics Office of the Company should be part of the General Counsel to ensure it has the institutional strength and clout of that department. At the same time, the ethics program needs to be part of the management responsibilities of each senior manager in their own area of the company. Compliance is everyone's job, both when it comes to obeying the law and also to being sure that the Company operates in a fully transparent and ethical manner.

55 It is important to note that the issue of governance, which affects loyalty and conflicts of interest, is not only internal to the structure, aiming at safeguarding loyalty, but is also systemic, delegated to watchdogs, such as external auditors and lawyers, whose collusion has played such an important role in recent scandals. The governance system of organizational loyalty routinely implies intervention by third parties for both monitoring and investigation. The boundaries of organizational loyalty have thus moved outside the organization both in relation to increased and strengthened public supervision but also in relation to the use of self-regulatory bodies performing standard-setting and external monitoring at industry or market levels. The analysis that follows will focus mainly on the interaction among different internal monitoring systems, taking into account where necessary the role of external monitors.

V. ORGANIZATIONS AS STANDARD-SETTERS: THE CHANGING ROLE OF CORPORATE DIRECTORS

To explore more deeply the implications of governance design for organizational loyalty, it is important to examine how contemporary corporations, especially publicly-owned ones, operate as standard-setters and then to compare this function with standard-setting in networks of firms and individual firms that operate within the network. In particular, given the functions the board has to play, we must examine how it exercises the standard-setting functions in relation to loyalty for its members, managers, and employees.[56] I have mentioned that standard-setting has grown, due to an increase in internal discretion and to proceduralization.[57]

Standards of organizational loyalty, by which I mean both those associated with the duties of loyalty and those related to governance, such as independence of directors, are complementarily defined both by law and by internal, legally-binding norms, which may or may not be enshrined in codes of ethics with regard to which the board generally plays a strategic role.[58] Social norms play a complementary role both as standard-setting and enforcing devices.[59]

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56 *See* OECD Principles, *supra* note 5.

57 It is useful to underline that these two developments are not conflicting but, rather, can be seen as balancing each other.

58 *See* OECD Principles, *supra* note 5:

> The board has a key role in setting the ethical tone of a company not only by its own actions but also in appointing and overseeing key executives and management in general. High ethical standards are in the long term interests of the company as a means to make it credible and trustworthy, not only in day to day operations but also with respect to long-term commitments. To make the objectives of the board clear and operational, many companies have found it useful to develop company codes of conduct based on professional standards and sometimes broader codes of behaviour. The latter might include a voluntary commitment by the company (including its subsidiaries) to comply with the OECD Guidelines for Multinational Enterprises which reflect all four principles contained in the ILO Declaration on fundamental labour rights. Company wide codes serve as a standard for conduct by both the board and key executives setting the framework for the exercise of judgement in dealing with varying and often conflicting constituencies. At a minimum the ethical code should set clear limits on the pursuit of private interests, including dealings in the shares of the company. An overall framework for ethical conduct goes beyond compliance with the law, which should always be a fundamental requirement.

For a specific reference to codes of conduct as a complementing device, see Coidicie Civilies [C.c.] art. 2409-octiesdecies (Italy) (in relation to the monistic model).

Legal systems and international soft law often call for special committees to complement legal provisions or policy guidelines by defining substantive or procedural initiatives to test the loyalty and self-dealing activities of directors.[60] In this case the committees operate as complements to standard-setters and as monitors of both their own conduct and that of their peers.[61] Shareholders may participate in different ways in the setting of standards and in the monitoring and sanctioning processes. Directors, individually or collectively, are often called on to play several roles within these committees: they are standard-setters and private enforcers of their own standards and of those applied to lower echelons, i.e., officers, managers, and employees.[62] They perform these functions for several purposes and their liabilities vary accordingly.[63] Directors are also called on to define compliance programs,

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59 See the papers published in U. Pa. L. Rev. (2001).

60 *See, e.g.*, Sarbanes-Oxley Act, *supra* note 7, § 301(4) ("Each audit committee shall establish procedures for (A) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and (B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters."). See also SEC Release No. 34,47516 (Mar. 17, 2003) 68 Fed. Reg. 14451 (Mar. 25, 2003), where it is stated that "a company's audit committee is required to adopt a formal written charter that specifies the scope of its responsibilities and the means by which it carries out those responsibilities, the outside auditor's accountability to the audit committee; and the audit committee's responsibility to ensure the independence of the outside auditor." The creation of an ad hoc committee also seems to be suggested by the newly reformed article 2381 of the Italian Civil Code, *see* Coidicie Civilie [C.c.] art. 2381 (Italy).

61 See also the adoption of this model as a possible alternative to the traditional model under the recent Italian law reform, Coidicie Civilie [C.c.] arts. 2408-09 (Italy).

62 See OECD Principles, *supra* note 5, No. 7, in relation to accounting and financial reporting:

> Ensuring the integrity of essential reporting and monitoring systems will require the board to set and enforce clear lines of responsibility and accountability throughout the organisation. The board will also need to ensure that there is an appropriate oversight by senior management ... . Companies are also well advised to set up internal programmes and procedures to promote compliance with applicable laws, regulations and standards ... compliance must also relate to other laws and regulations such as those covering securities, competition and work an safety conditions. Such compliance programmes will also underpin the company's ethical code. To be effective the incentive structure of the business needs to be aligned with its ethical and professional standards so that adherence to these values is rewarded and breaches of law are met with dissuasive consequences or penalties. Compliance programmes should also extend where possible to subsidiaries.

63 For a comparative study that addresses the liability of outside directors in different

by specifying standards of loyalty and conflicts of interest for managers and employees, and to contribute to the creation of organizational structures able to monitor conduct and report on and administer sanctions if violations occur. In this context, recent changes have involved not only governance but also working methodologies related to standard-setting, in particular reporting.[64]

To exercise these functions, the composition of the board and its internal organizational model gain great importance.[65] How do the composition and the work methods of the board affect the production and implementation of standards of loyalty? There is growing attention to the way the board should be organized.[66] Board organization is clearly linked to the composition

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areas of conflicts of interest, see Bernard S. Black et al., *Outside Director Liability* (Nov. 2003) (Stanford Law & Econ. Olin Working Paper No. 250), *available at* http://ssrn.com/abstract=382422; Bernard S. Black & Brian R. Cheffins, *Outside Director Liability Across Countries* (Dec. 2004) (Stanford Law & Econ. Olin Working Paper No. 266), *available at* http://ssrn.com/abstract=438321. Black et al., study the liability that outside directors nominally and actually incur for vigilance duties concerning the duty of care under corporate and banking law, the duty of disclosure under corporate and securities law, duties to creditors under corporate and bankruptcy law, and assorted duties under environmental pension and other laws.

64 Reports made to the board by committees but also by internal auditors at different levels of the chain do not necessarily refer only to specific violations since, as happens in many legal systems, the liability (criminal and often civil) of directors is now also linked to organizational design and in particular to failure to define an appropriate design, which cannot be conceived of as the sum of specific violations. Reports therefore can show the inadequacy of a particular organizational model. But the way reporting activity is organized is aimed at using reports as preventive devices for violations and as learning tools for those who have to design and implement loyalty standards.

65 Board composition criteria change in different legal systems in relation to several factors among which is the ability to delegate power to committees. U.S. corporate boards tend to be more regulated, as far as composition is concerned, but also in relation to the number and types of committees that have to be created. While it used to be the case that European legal systems were less regulated, recent reforms have increased the legislative rules affecting board composition and power delegability.

Board composition affects independence through rules that regulate the possibility for managers and employees to sit on the board, on the one hand, and prescribe a certain number of independent directors, on the other hand. For a comparative account, see Hansmann & Kraakman, *Basic Governance*, *supra* note 7, at 50.

66 See article 5 of the Draft Recommendation of the European Commission concerning organization in board committees. In particular, article 5.1 states:

> Boards should be organized in such a way that a sufficient number of independent non-executive or supervisory directors play an effective role in key areas where the potential for conflict of interests is particularly high. To this end, but subject to article 7, nomination remuneration and audit committees should be created within the (supervisory) board, when the latter (either by making decisions itself

issue. The internal composition of boards has changed in recent years with various patterns in different legal systems, and the increased number of independent directors has been suggested as a response to the need for impartiality and fairness in standard-setting, monitoring, and evaluating potential self-dealing.[67] Just how (un)successful the move to expand the number of independent directors has been is under scrutiny, but for our purposes, the question is whether different types of directors and committees provide different standard-setting procedures for organizational loyalty.

The need for independence has more general implications than the role of independent directors, to which I shall return. Independence implies differentiation and separation within the board and between the board and management to the extent that appropriate processes to produce information, to control, and mediate so require. Independence has both a horizontal dimension and a vertical dimension within the organization, and it varies in relation to the existence of hierarchical relationships. Vertical independence concerns the relationship between directors and managers, but also between managers and employees.[68] It is a typical requirement for internal control and audit. Once the link between independence and loyalty has been established, it should operate along the whole decision-making chain both in relation to standard-setting and monitoring. But independence cannot translate into separation between directors, managers, and employees, given the importance of information acquisition working from the bottom up within the firm and the different structure of decision-making associated with de-hierarchization. These modifications have increased vertical interdependence, which may

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or by making proposals for consideration by another corporate body) is playing a role in these areas under national law.

Id. art. 5.1. Article 6 then specifies: "The terms of reference of any committee created should be drawn up by the (supervisory) board. When permissible under national law, any delegation of decision-making power would have to be explicitly declared, properly described and made available to shareholders in a fully transparent way." *Id.* art. 6.

67 See the Sarbanes-Oxley Act, *supra* note 7, and the SEC rules concerning audit committees and the revised listing standards of both the NYSE and the NASDAQ concerning the board, which require listed companies to have a majority of independent directors and tighten the definition of independence. These changes have brought about functional modifications of the board and, to a large extent, have strengthened the preexisting tendency to externalize the locus of decision-making within the corporation. The board has become the locus of last resort to mediate among decisions that generally take place outside.

68 For a comparative account of different types of relationships between boards and managers, see Adams, *supra* note 7.

cause capture of directors by managers and distort their ability to monitor. When there is such a close relationship, there could be good reasons to export part of the monitoring function to external monitors, even given the cost of less-informed monitoring activity, because of the benefits of objectivity and impartiality.

In order to identify the features of a vertical chain of loyalty, vertical separability and coordination are, therefore, important. Governance design requires that different levels (board, senior officers, management, employees) be kept separate but coordinated.[69] Independence is, hence, embedded within a coordinated seam of relationships. Otherwise it would translate into a device that would weaken instead of increase accountability. Coordination implies a stronger information flow that has to be translated into disclosure policies and monitoring duties within the board and, more in general, between the board and other components of the organization.

VI. THE ROLE OF INDEPENDENT DIRECTORS IN ORGANIZATIONAL LOYALTIES: AGENTS WITH UNDEFINED PRINCIPALS?

Beyond the general dimension of a board's independence, there is a more specific profile concerning the role of independent directors as standard-setters.[70] Independence has been conceived as a key factor in several reform strategies to provide impartial standard-setting within the organization, but also to ensure the effective monitoring of conduct and, to some extent, impartial enforcement.[71] How different are independent directors

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69 This coordination may even require physical proximity:

> The Audit Committee should provide oversight of the adequacy and performance of the Internal Audit department. However for administrative purposes Internal Audit should report to the CFO subject to Audit Committee oversight. The head of internal audit and senior internal audit staff should be required to be physically resident at the Company's headquarters in Ashburn, Virginia to insure close coordination with the CFO and senior management.

Restoring Trust, *supra* note 6, at 110.

70 *See Draft Commission*, *supra* note 5.

71 On the definition of independence, see id. art. 13 (on non-executive and supervisory directors). It is worth noting, among other things, the recognition that "the ultimate determination of what constitutes independence is fundamentally an issue for the (supervisory) board itself to determine." *Id.* art. 13.2. In the annex, however, several criteria for defining independence are provided.

> [A] number of criteria should be adopted at national level. Such criteria, which should be tailored to the national context, should be based on due consideration of at least the following situations:

from executive directors as internal standard-setters for rules concerning loyal behavior?[72] The answer depends partly on the possibility of identifying which principals they act for. The link between ownership structure and agency is quite clear, but it is not the only variable to account for when explaining the new roles of independent directors.[73] If the independence of independent directors is mainly aimed at reducing the influence of controlling shareholders, clearly standard-setting tries to pursue the combination of interests represented in different constituencies, in particular minority shareholders and creditors.

In order to ensure proper performance of organizational functions, the distinction between independent and non-independent directors has, therefore, become crucial.[74] Who are independent directors? They are distinct

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> not to be an executive or managing director of the company or an associated company and not having been in such a position for the previous five years;
> not to be an employee of the company or an associated company and not having been in such a position for the previous three years ...;
> not to receive, or have received, significant additional remuneration from the company or an associated company apart from a fee received as non-executive or supervisory director ...;
> not to be or to represent in any way the controlling shareholder(s) ...;
> not to have, or have had within the last five years a significant business relationship with the company or an associated company, either directly or as a partner, shareholder, director or senior employee of a body having such a relationship ...;
> not to be or have been within the last three years, partner or employee of the present or former external auditor of the company or an associated company;
> not to have served on the (supervisory) board as a non-executive or managing director, or of persons in the situations referred to above.

Id. app. 1.2.

72 The growing emphasis on the dimension of independence as a basis for internal rulings by the organization on loyalty and self-dealing transactions further stresses the importance of a governance design that encompasses independence of the directors from both management and controlling shareholders. In many of the troublesome cases that have recently emerged, board majority was composed by formally independent directors who were, however, substantially prone to CEO and management.

73 On the link between ownership and independence, see OECD Principles, *supra* note 5:

> The manner in which board objectivity might be understood also depends on the ownership structure of the company. A dominant shareholder has considerable powers to appoint the board and the management. However in this case the board still has a fiduciary responsibility to the company and to all shareholders, including minority shareholders.

74 *See* Communication, *Modernizing Company Law*:

> In key areas where executive directors clearly have conflicts of interests (i.e. remuneration of directors, and supervision of the audit of the company's

from non-executive directors.[75] The focus in this paper on the duty of loyalty suggests that the problem is not related to interested directors and that the definition of independence is broader than that of interest.[76]

The definition of independence varies according to several criteria, and

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accounts), decisions in listed companies should be made exclusively by non-executive or supervisory directors who are in the majority independent. With respect to the nomination of directors for appointment by the body competent under national company law, the responsibility for identifying candidates to fill board vacancies should in principle be entrusted to a group composed mainly of executive directors, since executive directors can usefully bring their deep knowledge of the challenges facing the company and of the skills and experience of the human resources grown up within the company. Non-executive directors should, nonetheless, also be included and specific safeguards should be put in place to deal with conflicts of interests when they arise, for example when a decision has to be made on the reappointment of a director.

Modernizing Corporate Law, *supra* note 10, § 3.1.3. *See also* OECD Principles, *supra* note 5, § V.

75 It is clear that independent directors do not overlap with non-executive directors. *See* European Association of Securities Dealers, Corporate Governance Principles and Recommendations, Preamble 4 (2000): "Independent directors are a sub group of 'non executive directors': not all non executive directors are independent — such as appointees of major blockholders or staff, or directors who have material ongoing service contracts with the company."

76 It has been pointed out, for example, by the Court of Chancery in Delaware, that the test to evaluate the existence of a disabling interest is different from that concerning independence.

> "Independence" does not involve a question of whether the challenged director derives a benefit from the transaction that is not generally shared with the other shareholders. Rather it involves an inquiry into whether the director's decision resulted from that director being controlled by another. A director can be controlled by another if in fact he is dominated by that other party, whether through close personal or familial relationships or through force or will. A director can also be controlled by another if the challenged director is beholden to the allegedly controlled entity. A director may be considered beholden to (and thus controlled by) another when the allegedly controlling entity has the unilateral power (whether direct or indirect through control over the decision makers) to decide whether the challenged director continues to receive a benefit financial or otherwise upon which the challenged director is so dependent or is of such subjective material importance to him that the threatened loss of that benefit might create a reason to question the corporate merits of the challenged transaction objectively ... . The key issue is not simply whether a particular director receives a benefit from a challenged transaction not shared with the other shareholders or solely whether another person or entity has the ability to take some benefit away from a particular director, but whether the possibility of gaining some benefit or the fear of losing a benefit is likely to be of such importance to that director that it is reasonable for the Court to question whether

the standpoint of independent directors changes depending on the ownership structure.[77] When ownership is dispersed, independent directors are held to be a vehicle for aligning managerial conduct with shareholder interests. And when it is concentrated, the functions of independent directors are more oriented towards safeguarding minority shareholders.[78] This difference, relating to the structure of ownership, has great influence on governance design, particularly that associated with board composition, and should have a similar impact on the definition of standards of loyalty and the choice between prohibitory, compensatory, and authorization-based rules. Even within the same legal form, different ownership structures could imply different governance arrangements regarding loyalty and self-dealing. Furthermore, independence may have referral bases in interests external to the ownership structure of the firm, for example, those of creditors and financial institutions.[79] This is bound to play a significant role, once different

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valid business judgment or selfish considerations animated that director's vote on the challenged transaction.

Orman v. Cullman, 794 A.2d 5, 25 (2002).

77 *See* Modernizing Company Law, *supra* note 10, § 3.1.3 ("Certain minimum standards of what cannot be considered to be independent should be established at EU level.").

78 These principles are contemplated in codes of conduct. *See, e.g.*, Committee for the Corporate Governance of Listed Companies, Report: Code of Conduct § 3 (2002) (Italy):

> The Committee notes that the most delicate aspect in companies with a broad shareholder base consists in aligning the interests of the managing directors with those of shareholders. In such companies therefore, their predominant aspect is their independence from the managing directors. By contrast, where the ownership is concentrated, or a controlling group of shareholders can be identified, the problem of aligning the interests of the managing directors with those of shareholders continues to exist but there emerges the need for some directors to be independent from the controlling shareholders too, so as to allow the board to verify that potential conflicts of interests between the interests of the company and those of controlling shareholders are assessed with adequate independence of judgment.

Id. § 3.2.

79 On this perspective see European Association of Securities Dealers, *supra* note 75, § VI.1.b: "There should be a sufficient number of board members of character and skill who are independent of management, influential shareholders and other conflicting interests, such as staff, the state or suppliers of goods and services to the company and its group." *See also* Brussels Stock Exchange & Banking and Finance Commission, Corporate Governance for Belgian Listed Companies § I, B.2.2 (1998) [hereinafter BXS/CBF Dual Code]: "[A] director may be considered independent if ... he/she is not a supplier of goods or services of a nature which might interfere with the exercise of his/her independent judgement, nor is he/she a member of the firm of which the company's adviser or consultant is part ... ." With

organizational models are taken into account, in the definition of governance related to networks of firms.

In sum, the definition of standards, in general, and those concerning loyalty, in particular, has become a complex task that requires effective monitoring. This task is mainly allocated to board members but in different ways. A crucial role concerning the standard of loyalty is played by independent directors who act as agents of an often unidentified principal. This loose link between independent directors and owners' interests reflects a tension: there is a trade-off between impartiality and accountability. Independent directors may enjoy a high level of discretion but have a reduced degree of accountability. This problem should be resolved by using complementary accountability systems at least partially different from liability rules beyond reputational sanctions.

Directors are not only required to set loyalty standards but also to design governance so as to provide effective monitoring of compliance with standards. One of the main failures in the recent past has been inadequate and ineffective *ex-ante* and *ex-post* monitoring.[80] Proposals have been made to scrutinize performances and transactions of key members of the board and

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respect to conflicts of interest, the proposal of a directive about investment services also enlarges the concept of conflict in the same direction (article 16.1): "Member States shall require investment firms to take all reasonable steps to identify conflicts of interest between themselves, including their managers and employees, and their clients or between one client and another that arise in the course of providing any investment and ancillary services, or combinations thereof." See also SEC Release No. 34,47672 (Apr. 11, 2003), 68 Fed. Reg. 19051 (Apr. 17, 2003):

> [W]hen assessing the materiality of a director's relationship with the company, the board should consider the issue not merely from the standpoint of the director, but also from that of persons or organizations with which the directors has an affiliation. Material relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others.

Id. at 19053.

See SEC Release No. 34,47516 (Mar. 17, 2003), 68 Fed. Reg. 14451 (Mar. 25, 2003):

> Independent director means a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship, which, in the opinion of the company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.

Id. at 14452.

80 *Ex-ante* monitoring serves to ensure compliance, i.e., to prevent violations from occurring. *Ex-post* monitoring serves to ensure that sanctioning has taken place effectively and that reputational mechanisms associated with blaming and shaming have operated.

management in order to improve corporate accountability.[81] They are centered on new combinations of prizes and sanctions and reflect a different equilibrium between standard-setting and monitoring.

The design of organizational loyalty also encompasses incentive systems and is directed not only at punishing disloyal behavior but also at encouraging loyal conduct inside the firm as well as towards external stakeholders. Internal prize systems can be as effective as sanctions in promoting loyal behavior, but they are not sufficiently developed. This combination is crucial when the geometry of loyalty is spelled out and vertical monitoring and horizontal monitoring are integrated in a unified governance design.

Standard-setting, monitoring, and sanctioning should, therefore, all be thought of as processes that feed each other. For this reason, a system of organizational loyalty based on standards exclusively linked to single acts or transactions, such as the traditional prohibitory rules impose, is destined to be quite ineffective. It can cure the symptoms but not the disease. The decrease of trust and accountability should not lead to the increased use of prohibitory rules.

VII. THE DIMENSIONS OF LOYALTY IN ORGANIZATIONAL STRUCTURES

The traditional approach concerning monitoring of organizational loyalty and, in particular, related party transactions can be described as follows: the

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81 *See* Restoring Trust, *supra* note 6, § 5.09 (Annual Review of CFO):

> [N]ot less than once each year the Audit Committee should conduct a thorough review of the performance of the Company's CFO. This should include, but not be limited to, all transactions or payments of any kind between the CFO and the Company or any of its affiliates, suppliers, vendors, investors or entities affiliated with any such persons. This annual review should include all business and investing activities of the CFO, which should be disclosed to the committee in connection with any such review. The Committee's annual CFO evaluation should verify the absence of related party transactions of any kind between the CFO and the Company, compliance by the CFO with the Company's code of Conduct and Ethics Pledge and the absence of any involvement in profit-making activities outside the company other than investments in bona fide instruments or situations available to the public and wholly unrelated to the Company. In addition, such review should assess the CFO's record in the areas achieving transparency in financial reports, establishment and enhancement of internal controls, and overall competences and expertise. Such review should also review the CFO's progress each year in the recruiting and training of a high quality finance department staff.

lower the organizational level, the less peer monitoring is employed to leave room for hierarchical monitoring. Both types of monitoring may give rise to liability, but there are different operating rules and standards for defective peer and hierarchical monitoring.

Changes in power structure and allocation within organizations make this distinction opaque and force a rethinking of the interaction between vertical and horizontal monitoring. A new approach is needed, able to shape the interaction between the horizontal and vertical dimensions of organizational loyalty of which monitoring is only one, albeit a relevant aspect. While this interaction is crucial for every firm, it is their combination that varies according to the different models of firms and, to some extent, the legal forms they assume.

Having underlined the relevance of governance to explain and define standards and procedures concerning duties of loyalty and self-interested transactions, I now move to a more detailed examination of the geometrical dimensions governing duties of loyalty owed by different members to the company. I will specifically focus the analysis on the interaction between the vertical and horizontal dimensions of monitoring loyalty.

Traditionally the horizontal and vertical dimensions of loyalty have been considered separately, building on hierarchical models of organizations and reinforcing the separation of decision-making from implementation of corporate policy. This approach and the consequences it brings about in terms of legal instruments have been shown to be very weak especially in relation to loyalty. Hierarchy in firms tends to be more and more diluted and the control of disloyal behavior should be channeled towards the new power sites of the firm.[82] The horizontal dimension concerns *peer* monitoring among directors, managers, and employees. Together with the conventional aspect of loyalty concerning the relationship between directors and the company, a complementary aspect should be analyzed: the vertical dimension that cuts across the different layers of the organization. This dimension has emerged as a critical one in past years, when it became clear that independence of directors was an insufficient safeguard to ensure effective standard-setting and monitoring and that violations (for example, those concerning auditing) affected several organizational layers.[83] The vertical dimension

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82 For a detailed examination of the issue, see Raghuram G. Rajan & Luigi Zingales, *Power in a Theory of the Firm*, 113 Q. J. Econ. 387 (1998); Raghuram G. Rajan & Luigi. Zingales, *The Firm as a Dedicated Hierarchy: A Theory of Origins and Growth of Firms*, 116 Q.J. Econ. 805 (2002); Rajan & Zingales, *supra* note 45.

83 This has, in turn, amplified the role of whistleblowers and the necessity for their protection not only in relation to frauds in financial markets.

encompasses two different aspects. The first is associated with the duty to monitor and detect violations by upper-level officers, i.e., directors, towards lower-level officers, managers, and employees. This profile is relevant in relation to models that differentiate standards for each level without providing a coordination mechanism, as well as models that consider the entire loyalty chain defining correlated standards. The second aspect concerns the contents of duties of loyalty, associated with the possibility that disloyal behavior affects parties belonging to more than one organizational layer and the need to define consistent standards and to identify coordinated monitoring procedures.

The vertical chain of loyalty is generally framed within the duty of care dimension, i.e., the standard by which the monitoring of the lower level is judged is that of reasonable care or fault in civil law countries. More recently a potential correlation of the duty of loyalty to a duty to define an appropriate governance design has emerged in the domain of corporate criminal liability.[84] Such a duty plays (or should play) a relevant role in the field of corporate civil liability as well. Within the duty to design an appropriate organizational model, there is a subset of obligations concerning governance of internal control systems aimed at preserving organizational loyalty in the face of crimes related to misappropriation. The distinction is relevant to the extent that it changes the applicable standard of review. The opportunity to frame the duty to monitor disloyal behavior under the duty of loyalty is related to the necessity to coordinate the horizontal and the vertical dimensions now regulated by two or even three different standards.

In this context, I will, therefore, consider the duty to monitor disloyal conduct as functionally correlated to the duty of loyalty owed to the

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84 The standard of the duty of care to monitor lower levels within the organization varies in different legal systems going from gross negligence to ordinary care of professionals. In the U.S., *In re Caremark* has defined the standard:

> Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability-creating activities within the corporation, as is in Graham or in this case, in my opinion only a sustained or systematic failure of the board to exercise oversight — such as un utter failure to attempt to assure a reasonable information and reporting system exists — will establish the lack of good faith that is a necessary condition to liability. Such a test of liability — lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight is quite high.

In re Caremark Int'l Inc., 698 A.2d 959 (Del. Ch. 1969). In Italy the recent reform of corporate law has specified the standard of care that directors have to comply with. *See* Codicie Civilie [C.c.] § 2392 (Italy) ("Directors must fulfill the duties imposed on them by them and the bylaws with the diligence required by the nature of the office and their specific powers.").

organization by the monitored parties. According, I will speak of a vertical dimension of loyalty, since I am considering the duty to monitor aimed at preventing disloyal conduct. The aim is to show that appropriate consideration of the governance design, in particular, that associated with standard-setting, monitoring, and adjudication, has and should feed back into the standards of loyalty in relation to the vertical dimension and, given the different hierarchical dimension that exists in large corporations, in relation to the horizontal dimension as well. Above, I differentiated between standard-setting and monitoring concerning loyalty within organizations. I focused more on standard-setting, suggesting that different actors, particularly independent directors, have been called on to play a strategic role in the definition of internal rules and procedures related to self-dealing but, more generally, to ethical norms that ensure loyalty to the company and its stakeholders. I also suggested that perhaps no less important is the monitoring function concerning implementation of those standards. The current debate often assumes that standard-setting and implementation of rules concerning loyalty are easily distinguishable and should deal with different duties. But standard-setting and monitoring, as a part of implementation of corporate policymaking, are not so easily separable as some proposals for reform seem to imply. In the field of corporate governance, we are witnessing a paradigm shift in the area of monitoring associated with higher organizational complexity. This complexity, due to the interaction of different organizational layers and redistribution of power among them, shows that monitoring is increasingly becoming a reflexive process in which the monitors and monitored interact in a learning process where traditional hierarchy is less and less effective. Strategic information and knowledge are often located in lower levels, and for this reason, it is important to design systems that favor disclosure and reduce the likelihood of opportunistic use of this information. From monitoring as oversight, we are moving to monitoring as planning and learning.[85] This is not to say that the control function of monitoring based on hierarchy is totally lost, but, rather, it is complemented by other functions.

Such different features of monitoring are particularly clear when they exist within the board among peers, but they also, and probably more interestingly, arise in vertical contexts, when directors have to monitor management's loyalty and integrity. But the definition of hierarchy between board members and managers is even more problematic given the power that

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85 *See* Charles F. Sabel, *Learning by Monitoring*, *in* Handbook of Economic Sociology 137 (Neil J. Smelser & Richard Swedberg eds., 1994).

management can exercise over directors and the necessity of separating the latter from the former to guarantee impartiality and fairness in the interest of the company.

These changes should affect, in turn, both the structure and content of the duty of loyalty and the governance design aimed at implementing it. If monitoring is less hierarchical, due to changes within the organization, and if the correlation between standard-setting and monitoring internal to the organization becomes closer, then standard-setting concerning loyalty becomes a reflexive process that should encompass the final recipients of the standards (i.e., parties who have to apply the rules) in the definition of the procedures and its revisions. For example, both the business judgment rule and the fairness test used in the United States should be reinterpreted accordingly.

Such changes warrant a higher degree of proceduralization that can decentralize responsibilities for standard-setting and monitoring but, at the same time, increase accountability through coordination and transparency, not only in the interest of shareholders but also of creditors and, more generally, financial institutions.

A. Horizontal Monitoring

Following this pattern I will first briefly analyze the more conventional horizontal dimension and then introduce vertical monitoring systems as additional profiles that (1) affect the level and quality of organizational loyalty and (2) preserve correct incentives to avoid or deter conflicts of interest.

The horizontal dimension is currently very relevant in relation to the board of directors, and it decreases going down the line of organizational layers. This dimension is strongly affected by the governance system, be it monistic or dualistic, and varies according to legal form and type of work organization, in particular, with the way layers are defined and coordinated.

Monitoring by directors or other board members presents specific difficulties associated with the relationships that arise among peers but also by the implicit, yet very influential role that subordinate management may informally have and the way they can influence relationships among directors. The tensions of internal relationships among the members of the board have been described to suggest reasons that make it more difficult to exercise peer monitoring and to underline the differences with vertical monitoring where a formal hierarchical relationship exists.[86]

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86 *See* Lucian A. Bebchuk, *Symposium on Corporate Elections* (Nov. 2003)

Within the board of directors there is both individual and collegial responsibility specifically related to monitoring.[87] Each director individually owes a duty of loyalty to the company. The members of the board have a duty to monitor each others' conduct and, in the specific context of a conflict of interest, are called on to perform a crucial function when, after disclosure, they are asked to approve or reject the transaction. When authorization-based rules are adopted, committees, both internal and external to the board, have come to play a very relevant role in defining standards and enforcing them in relation to loyalty.[88] This function indicates that there is collective responsibility to set standards and to monitor them in order to verify that each director is complying with the organizational duties. Collective responsibility ensures that monitoring is effective and should reduce incentives to collude in the adoption of disloyal behavior. Committees have duties to acquire information, to ensure that reporting is appropriately performed.

In the context of conflicts of interest, if an interested transaction takes

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(Harvard Law & Econ. Discussion Paper No. 448), *available at* http://ssrn.com/abstract=471640; Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. Cinc. L. Rev. 1233 (2003).

87 The importance of collective responsibility is stressed by the European Commission. See Modernizing Corporate Law, *supra* note 10, at 18. On the collective liability of directors and a new sanctioning system, see also High Level Group of Company Law Experts, Report on a Modern Regulatory Framework for Company Law in Europe 67 *passim* (2002). *But see* Coidicie Civilie [C.c.] art. 2392 (Italy):

> Directors ... shall be jointly and severally liable to the company for losses arising from failure to fulfill [their] duties, unless the latter belong to the executive committee or are explicitly assigned to one or more directors. The directors ... shall always be jointly and severally liable if, even though aware of harmful facts, they did not do all in their power to prevent the conclusion thereof or to eliminate or attenuate their harmful consequences. The liability for the actions or omissions of the directors shall not extend to any among them who, being without fault, had his or her dissent entered without delay in the book of board meetings and resolutions, giving immediate notice thereof in writing to the chairman of the board of auditors.

For an application of the same article before the reform, see Cass., sez. un., 2001, n. 5443, about liability for failure by the president of a company to properly monitor a director acting as representative of the company, and Cass., sez. un. 1998, n. 3483 [hereinafter Cass. 3483/98], about a joint liability case in a conflict of interest transaction.

88 The introduction of committees mainly or entirely composed by independent directors opens new questions concerning liability. Are committees, such as the governance committee or the auditing committee liable for the function they play or do they just represent a sub-structure of the board, so that liability continues to be either individually or collectively allocated to the entire board?

place, liability falls not only on the director who has made the transaction without appropriately disclosing the material facts, but also on the other directors who have failed to monitor and prevent the violation. Collegiality implies a collective responsibility for activities carried out by the board as a body.[89] The transformation is more relevant in relation to activities that do not materialize in a single transaction to be approved or rejected, but are continuous in time and need to be permanently monitored. Failure to perform the monitoring function or negligent approval of interested transactions is a violation of the duty of care that translates into liability for the other directors. Peer monitoring is therefore a core function of the board.

These duties are generally regulated under a duty of care framework, but they should be conceived as part of the organizational loyalty system, especially given the new governance mechanisms designed to increase information circulation and decrease the probability of corporate crimes. The changing nature of peer monitoring and the increased reflexivity impose a higher level of correlation between monitors and monitored than that compatible with framing the duty to monitor under a duty of care dimension.

Monitoring concerns not only loyalty but also independence of monitors. *Quis custodiet custodies?* Independence needs to be monitored, but how? Independence is not a permanent status, but, rather, requires continuous monitoring since it is a combination of the objective requisites of the position occupied by the person involved and his or her behavior during his or her tenure. It is therefore subject to periodic scrutiny and may bring about changes in the composition of the board or the committees responsible for deciding if the director in question has lost this quality.[90] The importance of

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89 See in Italian case law, Cass. 3483/98, *supra* note 87.

90 On the monitoring function of the supervisory board concerning directors' independence, see article 13 of the Draft Recommendation of the European Commission:

> Since the criteria should be met throughout the entire tenure, companies should also disclose annually which directors they consider to be independent; when one or several of the criteria retained at the national level for assessment of independence of directors has not been met throughout the year the company should disclose its reasons for considering this director to be independent. To ensure the accuracy of the information provided on the independence of directors, the company should require the independent directors to revalidate their independence periodically.

Draft Commission, *supra* note 5, art. 13. There are countries in which independent directors outnumber dependent directors, and yet the values typically ensured by independent directors are not part of the business culture.

integrating standards of loyalty and governance design is clearly shown when formally effective rules are administers by partial and interested directors.

B. Loyalty in the Vertical Dimension

A duty of loyalty is owed by different members of the organization: directors, officers, senior managers, and employees. Every layer of the organization is burdened by a duty of loyalty whose contents depend on the specific functions but also on the involvement in collective activity. Within this duty a specific dimension is occupied by conflicts of interest, more relevant for the directors than for managers or employees. This duty is generally regulated by corporate law and/or by labor law and by codes of conduct or codes of ethics.[91] In organizations characterized by large, complex, and hierarchical structures, standards of loyalty concerning managers and employees are defined by law, but mainly by internal disciplinary protocols, guidelines, and regulations.

The changing structure of the firm and partly new styles of industrial relations have increased the contractual nature of these internal guidelines. The standards are defined through negotiations, and they also require different governance mechanisms from conventional disciplinary committees. Unlike in the case of horizontal monitoring, here standard-setting and monitoring are generally performed by different bodies. However, the converging dimensions of horizontal and vertical loyalty have often contributed to the creation of unified auditing structures dealing with loyalty issues at all levels. But there is still a strong presence of diversified governance mechanisms to administer loyalty at lower levels of the firm in more traditional organizations.

The new roles for audit committees defined in US legislation and regulations, especially by the SEC and listing requirements of the NYSE and the NASDAQ, show a move from *command and control* to *incentive-based* regulation in standard-setting for loyal behavior. In turn, this is transforming vertical monitoring from pure oversight into an interactive process with a

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91 As we shall see, a somewhat unifying dimension is provided by a code of ethics or a code of conduct where all the levels of the organization are covered by a relatively more homogenous set of principles.

combination of mediation and negotiation among the different levels and between monitors and monitored.[92]

Traditionally, compliance with the standard is monitored by the upper level, generating a vertical chain of loyalty. Standards vary according to the different types of rules, and compliance control adjusts accordingly. The presence of prohibitory rules is higher going down the chain in accordance with the hierarchical concept of the firm, but some changes have been introduced especially through codes of conduct. Different governance mechanisms are associated with different rules concerning management and employee loyalty. Thus, a set of prohibitory rules for employees requires different monitoring systems than authorization-based rules or compensatory rules that translate into different governance designs. A higher level of discretion in the definition of standards, that is, moving away from prohibitory rules, implies generally the necessity of ensuring impartiality of control over loyalty. An independent actor, an internal audit committee, or an external entity would be required to monitor.[93]

When the potential violation can cross different layers, it is important to examine how these duties operate contextually, to preserve organizational loyalty and the functional correlation among them; that is to say, we must ask whether the duty of loyalty owed by employees to the employer is somewhat content-related to that owed by managers to directors and by directors to shareholders, so that one can define the existence of a chain at least in relation to some of the functions. This occurs mainly when the task is particularly complex and requires the involvement of different competences

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92 The process might resemble something more like "mediation", as when, for example, the audit committee must dissolve disagreements between management and the company's independent auditor. See 15 U.S.C.A, par. 78j-1(m) (2) (West Supp. 2003) (empowering audit committees to resolve such disagreements). While this process might not be pure negotiation, the point is that the board can in such reviews adopt a role resembling negotiation more than monitoring or oversight. They can do so by openly acknowledging management's conflicting interests and actively debating on potential risks and rewards of alternative approaches, rather than taking a monitoring or policing stance that at least implicitly frames disagreements with management as resulting from suspicion of dishonestly or breach of duty.

Note, *And Now the Independent Director! Have Congress, the NYSE, and NASDAQ Finally Figured out How to Make the Independent Director Actually Work? Developments in the Law: Corporations and Society*, 117 Harv. L. Rev. 2169, 2185 n.23 (2004).

93 See, for instance, the recent case concerning ENIPower, an Italian company where the parent ENI decided to appoint an external monitor for investigations concerning presumed corruption, IL sole 24 Ore August 2004.

located in various points of the organization. (I do not address here the related issue of the structure of the loyalty chain when competences, instead of being found inside the firm, are acquired in the market.[94])

Together with the functional connection associated with the organization of work within the firm, there is another relevant dimension concerning the duties placed on the organizational upper level to monitor compliance of the lower level. Directors are responsible for ensuring that managers do not violate labor law, human rights law, environmental law, product liability law, antitrust law, etc., and, even beyond legal standards, that they comply with internal policies concerning these and loyalty-related matters and with codes of conduct (for example, corporate social responsibility).[95] Managers are responsible towards employees in the same manner and so on, along the chain.

C. The Features of Vertical Monitoring Concerning Organizational Loyalty: Hierarchy, Independence, and Reflexivity

Why do firms currently have a vertical chain of control based on duties of care, in particular concerning compliance with the duty of loyalty?

The conventional agency explanation is that the existence of a monitoring chain going vertically top-down is functional to reducing monitoring costs by owners. Shareholders in corporations monitor directors, who, in turn, monitor managers, who monitor employees. There is a trade-off: the fragmentation of monitoring may increase costs of coordination, but costs are also decreased by proximity. The creation of a monitoring chain, where each node takes responsibility, is a device to substitute direct with indirect monitoring. Certainly vertical monitoring is not costless, but it is much cheaper than direct monitoring of shareholders. Therefore, shareholders will monitor employees' loyalty indirectly, by monitoring directors' compliance of their duty to monitor managers and employees, whenever the size of the organization and

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94 For example, the interaction between loyalty standards applied to directors and managers and those applied to legal and financial counsels hired on a contractual basis for a specific deal or as permanent consultants. In this case, the difficulty in distinguishing between a horizontal and a vertical dimension may be greater because it is relatively difficult to frame consulting in a hierarchical mode and the correlation of standards of loyalty would imply a coordination between corporate and contract law.

95 For a comparative analysis concerning directors' liability in relation to duties other than conflict of interest related duties, see Black et al., *supra* note 63; Black & Cheffins, *supra* note 63.

its governance structure makes indirect monitoring cheaper. Organizational design and standards of duties are aimed mainly at saving agency costs while ensuring efficacy of monitoring.

But how is the vertical chain designed? In order to exercise appropriate vertical monitoring, a clear functional separation is required among different organizational layers. The role of eligibility and compatibility in becoming part of the chain is highly relevant. An important dimension concerning the features of the vertical chain is that of incompatibility regimes, for example, those associated with the position of directors of the board. The main implication is the principle of separation between the board of directors and management, which has recently gained strength in some legal systems.[96] This should imply limiting the possibility of employees becoming directors.[97]

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96 The French reform, introduced by la Nouvelle Regulation Economique, has redefined the internal power distribution of *sociétes anonymes*. With the Law No. 2001-420 of May 15, 2001, J.O., May 16, 2001, at 7776, the principle of functional separation was introduced. However, since functional separation is not coupled with personal separation, the president of the board of directors may also be general director. The strength of the separation is, therefore, quite limited, at least from the point of view analyzed in the paper. On the new structure of power in the *sociétes anonymes*, see Marie H?l?ne Monserie-Bon, *L'organisation des pouvoirs au sein de la société anonyme*, *in* La loi NRE et le droit des sociétés, Collection Les Grands Colloques 23, 25 (2003).

97 *See, e.g.*, Restoring Trust, *supra* note 6, § 1.10:

> The company's Articles of incorporation should set forth standards for defining independence of a board member. These standards should include specifications that a director is not independent if under any of the following circumstances:
>
> (a) The individual or any close relative by blood or marriage is currently or has been an employee of the company within the past five years with compensation above a level specified by the board, such as 75.000 dollars;
>
> (b) The individual receives (or within the past three years has received) any form of compensation for services as an employee, or as any outside consultant or other professional retained by the Company other than standard fees for board or committee service and is not a partner or employee of any law firm, investment banking firm or other firm providing professional services to the company;
>
> (c) If the individual is an officer, director, partner or employee of any firm that does business with the company, the director shall not be independent if the volume of cross-business exceeds a level set by the board with 1% of revenues for either firm or $3 million in any three year period as recommended starting level ...
>
> (d) If the individual serves as an officer of any company on whose board an officer of the Company sits, the individual is not independent while any such interlock is in effect;
>
> (e) If the individual is an officer, director or employee of a non profit organization

This problem is related to the meaning of independence from executive directors, outlined in the previous section in relation to the horizontal dimension, and, more generally, to the role of independent directors. A different regime for independent and non-independent directors is also necessary in relation to vertical monitoring given the role they have in audit committees, for example. Here the core issue is the independence of directors from managers and employees.

To implement the separation principle it should be clear that independent directors ought not to have an employment relationship with the organization. But even for executive directors to have an employment relationship may be highly problematic for the overlap between the controller and controlled.[98] Every time there is such an overlap between two layers in the vertical loyalty chain, a high risk of under-deterring disloyal behavior, in particular conflicts of interest, occurs.

Legal systems have different attitudes toward this issue. Some allow the possibility of an executive director having an employment relationship with the company, but limit the number of such directors.[99] Some do not define a minimum number but, instead, identify rules that circumscribe the risks associated with this overlap.[100] Codes of conduct define general rules concerning independent directors preventing them from engaging in business or economic relationships, including employment relationships.[101] Less attention is devoted to executive directors and their independence from

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that receives donations from the company in excess of $ 100.000 during any year ... .

98 It should be pointed out that here we are concerned with the possibility that a director is at the same time an employee. A different question concerns the possibility that the contractual relationship between director and company is regulated by an employment contract.

99 The French system allows this possibility, but the directors-employees cannot overcome the limits of a third. *See* Maurice Cozian et al., Droit des Sociétés 286 (15th ed. 2002).

100 The Italian system does not prevent employees or managers from becoming directors.

101 See, for example, the Combined Code of Corporate Governance in UK, last revised July 2003, which states:

> The board should identify in the annual report each non-executive director it considers to be independent. The board should determine whether the director is independent in character and judgment and whether there are relationships or circumstances which are likely to affect, or could appear to affect the director's judgment. The board should state its reasons if it determines that a director is independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination, including if the director:

- has been an employee of the company or group within the last five years;
- has or has had within the last three years, a material business relationshipwith the company either directly or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
- has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme or is a member of the company's pension scheme;
- has close family ties with any of the company's advisers, directors or senior employees;
- holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- represents a significant shareholder; or
- has served on the board for more than nine years from the date of the first election.

Financial Reporting Council, Combined Code on Corporate Governance § A.3.1 (2003). See the Norby Report & Recommendations, which states:

> [I]t is important that the board is composed in such a way that ... directors can act independently of special interests ... . In this context, an independent director elected by the general meeting can not:
>
> - be an employee in the company or be somebody who has been an employee in the past five years;
> - have been a member of the management of the company;
> - be a professional consultant to the company or be employed by or have a financial interest in, a company which is a professional consultant to the company;
> - have some other strategic interest in the company other than that of a shareholder. We cannot recommend that managers of a company are also directors of the company. This also applies to situations in which major shareholders are managers of a company as well as directors at the same time. In companies with one major shareholder, the board should pay special attention to the safeguarding of the other shareholders' interests on equal terms with the major shareholder's interests at all times.

Norby Committee, Report on Corporate Governance in Denmark: Recommendations for Good Corporate Governance in Denmark (2002). *See also* Swedish Shareholders' Association, Corporate Governance Policy: Guidelines for Better Control and Transparency for Owners of Companies Quoted on the Swedish Stockmarket § 2.1 (2003) (under which no employees, apart from the managing director, should be included in the board). The Dual Code of the BXS/CBF states that:

> a director may be considered independent if he/she is not a member of the executive management or of the board of associated companies (subsidiaries etc.) ...; he/she has no family ties with any of the executive directors which might interfere with the exercise of his/her independent judgement; he/she is not a member of the executive management or board of directors of one of the dominant shareholders and has ... no business, financial or other relationship with the latter; he/she is not a supplier of goods or services of a nature which

> might interfere with the exercise of his/her independent judgement, nor is he/she a member of the firm of which the company's adviser or consultant is part; he/she has no other relationship with the company which ... might interfere with the exercise of his/her judgement ... could be exercised upon him or her ... .

BXS/CBF Dual Code, *supra* note 79, pt. I, § B.2.2. See the Principles of Corporate Governance, defined by the Business Roundtables concerning Board Composition and Leadership:

> The board of a publicly owned corporation should have a substantial degree of independence from management. Board independence depends not only on directors' individual relationship — personal, employment or business — but also on the board's overall attitude toward management. Providing objective independence is at the core of the board's oversight function, and the board's composition should reflect this principle. Board independence: Assessing independence: An independent director should be free of any relationship with the corporation or its management that may impair, or appear to impair the director's ability to make independent judgments. The listing standards of the major securities markets relating to audit committees provide useful guidance in determining whether a particular director is "independent." These standards focus primarily on familial, employment and business relationships. However, other kinds of relationships, such as close personal relationships, between potential board members and senior management may affect a director's actual or perceived independence.

The Business Roundtable, Principles of Corporate Governance 10 (2002). *See* Anna C. Cavallari et al., Borsa Italiana, Corporate Governance in the Italian Listed Companies § 3 (1999), *available at* www.borsaitalia.it/opsmedia/pdf/11858.pdf; see, for France, the report of working group chaired by Daniel Bouton on behalf of MEDEF and AFEP-Agref:

> For purposes of clarity, the criteria that the committee and the board should examine in order to determine whether a director can be called independent and help avoid the risk of conflict of interest between the director and executive management, the company or its group should be as follows:
>
> The director is not an employee or corporate officer (mandataire social) of the company, nor an employee or director of its parent or of one of the consolidated subsidiaries, and has not been one during the previous years.
>
> The director is not a corporate officer of a company in which the company holds, either directly or indirectly, a directorship or in which a directorship is held by an employee of the company designated as such or by a current or former (going back five years) corporate officer of the company.
>
> The director is none of the following (whether directly or indirectly) a customer, a supplier investment banker or commercial banker-in each case
>
> 1. which is material for the company or its group or,
> 2. for which the company or its group represents a material proportion of the entity's activity.
>
> The director does not have any close family ties with a corporate officer (mandataire social) of the company.
>
> The director has not been an auditor of the company over the past five years

management.[102] The need for coordination between different layers is much higher here, but it would still be appropriate to separate executive directors and management.[103]

The issue of independence leads also to the question concerning internal investigation when there is reason to believe that violations concerning organizational loyalty have occurred. While internal auditing and self-reporting can operate effectively to monitor *ex ante*, reporting when the suspect of violations is high should be provided by external independent bodies. Likewise, *ex-post* reporting should be allocated to impartial bodies that can have independent judgments. These bodies can be part of the organization, but they should be separate and located, for example, in a separate audit division.

In the vertical chain of loyalty, therefore, the distinction between self-reporting and external reporting is relevant, as it is in the horizontal dimension. In both cases, of self-reporting and external reporting, it is important that the body that receives the claim concerning the violation operates according to a procedure that protects the party, especially if he or she is an employee.[104]

The director has not been a director of the company for more than twelve years. Daniel Bouton, MEDEF & AFEP-Agref, Promoting Better Corporate Governance in Listed Companies 10 (2002).

102 *But see* OECD Priniciples, *supra* note 5:

> The variety of board structures, ownership patterns and practices in different countries will require different approaches to the issue of board objectivity. In many instances objectivity requires that a sufficient number of board members not be employed by the company or its affiliates and not be closely related to the company or its management through significant economic, family or other ties. This does not prevent shareholders from being board members..

103 *See* OECD Principles, *supra* note 5, § E:

> In order to exercise its duties of monitoring managerial performance, preventing conflicts of interest and balancing competing demands on the corporation, it is essential that the board is able to exercise objective judgment. In the first instance this will mean dependence and objectivity with respect to management with important implications for the composition and the structure of the board. Board independence in these circumstances usually requires that a sufficient number of board members will need to be independent of management. In a number of countries with single tier board systems the objectivity of the board and its independence from management may be strengthened by the separation of the role of the chief executive and chairman or, if these roles are combined, by designating a lead non executive director to convene or chair sessions of the outside directors.

104 This issue has been left open. It is unclear whether when deciding different internal policies, organizations can still preclude through confidential agreements external reporting or can direct internal reporting. It is unclear whether reporting should

As previously emphasized, independence is also relevant in the relationship between firms, listed companies, and external controllers such as audit firms.[105] It is worth noting that independence here is related not only to the possibility of being a director in both companies (the auditing and the audited firm) but also to being or to having been an employee of the audited firm during the past five years.[106] These rules once again demonstrate the relevance of the vertical loyalty chain in its diagonal dimension: an employee of the audited firm cannot become an independent director of the auditing firm in the five years after employment has ceased.

Separation among organizational layers in hierarchical firms is crucially associated with coordination, and the set-up of the monitoring chain should be considered an important device for insuring that coordination occurs.

For vertical monitoring we have distinguished between *ex-ante* and *ex-post* monitoring. In this respect it is important to identify the incentives system located at the core of the vertical chain, because the mix between liability threats for failure to monitor and contract-based incentives to detect violations and ensure compliance may be quite diverse. It is necessary to identify the right combination in order for the system to be effective.

Shareholders monitor directors to avoid suffering harms from disloyal behavior, in particular, that of self-dealing by different members of the firm. Directors, unless their contracts provide otherwise (i.e., remuneration through stock options), monitor managers in order to escape liability.[107] Only to the extent that they have a proprietary interest in the corporation would their monitoring be based on other incentives. Likewise, managers monitor employees in order to escape liability unless contracts provide for additional

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follow a hierarchical chain going bottom-up or a completely different route going directly to the ethics committee or to the audit committee.

105 See, for example, the new Corporate Governance Rules Proposals of the New York Stock Exchange, NYSE, *supra* note 40.

106 *See id.* § 330A(b)(i) ("No director who is a former employee of the listed company can be 'independent' until five years after the employment has ended."). *See also* Sarbanes-Oxley Act, *supra* note 7, § 206:

> It shall be unlawful for a registered public accounting firm to perform for an issuer any audit service required by this title, if a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer, was employed by that registered independent public accounting firm and participated in any capacity in the audit of that issuer during the 1 year period preceding the date of the initiation of the audit.

107 There are two relevant issues: one concerns disclaimers and indemnification clauses and the other relates to monetary incentives associated with performances.

or complementary pecuniary and non-pecuniary incentives. Frequently, an appropriate contractual structure integrates the liability system by giving pecuniary and career-based incentives to managers for monitoring employees' loyalty.[108] Their remuneration is associated, among other things, with the level of compliance of the lower level in the organization, and it may be specifically tied to loyalty objectives.

In order to administer prizes and sanctions effectively, the ability of the firm to perform as a private enforcer becomes crucial, sanctioning violations directly and thereby saving on adjudication costs and ensuring the implementation of social norms. To the extent that the creation of a vertical chain of loyalty is integrated with the power to directly enforce standards of loyalty concerning the lower level without having to resort to judicial intervention, there is certainly a significant efficiency gain. Of course, this ability cannot translate into discretionary or discriminatory power, and strong safeguards are or should be supplied to ensure that abuses do not occur. As we shall see, civil rights in the workplace may provide incentives for protection.

The interaction between the duty of care (specifically concerning monitoring), as the monitoring function is currently framed, and the duty of loyalty increases when the reflexive dimension of monitoring is stressed. If monitoring results in pure control over compliance concerning individual transactions, then care and loyalty are easily separable analytically. This is especially true in relation to the use of prohibitory rules. But if monitoring is a relational function applied to long-term and complex activities where the monitors partly depend on information provided by the monitored and may even learn from them, loyalty cannot be based on hierarchy. This is particularly true where authorization-based rule or compensatory rules are in place. In addition, independent directors and audit committees often depend very strongly on information held by the executive directors or managers.

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108 *See* Rock & Wachter, *supra* note 25, at 671:

> Firms control work effort through a variety of intrafirm mechanisms, including merit pay, promotions and other such devices that align the interests of employees with those of the firm. With frequent interacting, the few bad players who find shirking more profitable than any other alternative can be identified and punished through demotions or discharge. In these later cases the disciplinary process tends to rely on the judgment of disinterested individuals such as supervisors, whose own incentives are in alignment with those of the firm. The same type of mechanism applies throughout the organization, even to executive officers and directors. For interested director transactions the other disinterested directors have interests that remain aligned with the corporation.

Vertical asymmetric information cannot be solved by creating hierarchical relations between directors and managers, even within the board, for the purpose of increasing loyalty. Vertical interdependence limits the application of the separation principle. Therefore, incentives and cooperative procedures are needed to generate information enabling the committees to perform their standard-setting and monitoring functions appropriately.

Within this framework, monitors, who are also standard-setters, feed back the knowledge acquired while monitoring when setting the standards. The monitored parties, those who should comply with the standards set by the monitors, will be able to channel reactions, feeding the process of designing appropriate rules. Then it (should) become clear why the duty to monitor should be considered part of the more general system of organizational loyalty.

D. Vertical Monitoring from the Bottom Up

The duty to monitor, which operates within horizontal relationships and the vertical chain of organizational loyalty, is the main feature of a governance design, suggesting that loyalty is ensured by the adoption of an organizational model as well as compliance with the duties. The structure of the organization, the ways vertical cooperation is defined among different levels, and the way the tasks are determined affect the rate of compliance with the duty of loyalty for each layer and for the organization as a whole. The violation of a duty of loyalty by the lower level often implies liability of upper level for failure to monitor or failure to have implemented an appropriate organizational model.[109] Lack of compliance with the duty to

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109 See from Italian case law Cass., sez. un. 1999, n. 661 (liability of the chief director for transactions enacted by a chief officer, such as unlawful constitution of money funds abroad); from U.S. case law see *In re* Caremark Int'l Inc., 698 A.2d 959, 971 (Del. Ch. 1996):

> In order to show that Caremark directors breached their duty of care by failing adequately to control Caremark's employees, plaintiffs would have to show either (1) that the director knew or (2) should have known that violations of law were occurring and, in either event, (3) that the directors took no steps in a good faith effort to prevent or remedy that situation, and (4) that such failure proximately resulted in the losses complained of.

Guttman v. Huang et al., 823 A.2d 492, 507 (Del. Ch. 2003):

> [I]t is perhaps possible for the common law of Delaware corporations to consider the imposition of a disgorgement remedy on independent directors when it is proven that: (1) the corporation did not have in place a rational process to guarantee the integrity of its financial statements because the independent directors breached their fiduciary duty through a cognizable failure of due care

monitor causes liability and may bring about organizational sanctions (i.e., removal or other disciplinary sanctions) together with compensatory ones, which are often not as effective.

Thus far I have considered the vertical dimension of organizational loyalty going top-down. A relatively neglected dimension of loyalty is the *vertical bottom-up* aspect. This dimension is generally not characterized by the existence of legal duties but by rules of protection for lower levels that face the unpleasant alternative between being silenced and being fired.[110] There is not a general duty of employees to monitor the loyalty of upper level managers, nor a duty of managers to monitor directors. But there might be duties to inform about unlawful activities that employees and managers observe because of their positions in the organization or even for incidental causes. In fact there is a relevant monitoring activity taking place in different forms that permits identification of a complementary vertical chain moving bottom-up.

Very often the bottom-up loyalty chain is organized through incentive systems as opposed to liability systems. This is partly a consequence of

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(i.e. gross negligence in the words of the key precedents; (2) as a result of this gross failure in due care, company insiders caused the company to release materially misleading financial statements that led market participants to value the company's stock at an artificially high price; and (3) the independent directors, without knowledge of the actual status of the company's financial health and subjectively believing that the financial statements were materially complete and accurate, nonetheless sold shares and profited at the expense of public buyers, and caused the company to suffer injury.

See also In re Kolar, SEC Release No. 46,127 (Jun. 26, 2002) (on the violation of registration and antifraud provisions of securities laws by a salesman, as supervised by a metropolitan area manager of the firm); SEC Press Release 2003-82, SEC, SEC Alleges Violations of Mutual Fund Sales Practice Requirements, Sanctions Prudential Securities, Incorporated (July 10, 2003), *available at* http://www.sec.gov/news/press/2003-82.htm (about the failure to supervise a firm representative by a branch office manager over the compliance with firm's policies and procedures regarding the sales of mutual fund shares, in circumstances in which both the firm and the representative obtained profits from the violation).

110 OECD Principles, *supra* note 5, § VI.6:

> In fulfilling its control oversight responsibilities it is important for the board to encourage the reporting of unethical/unlawful behavior without fear of retribution. The existence of a company code of ethics should aid this process which should be underpinned by legal protection for the individuals concerned. In a number of companies either the audit committee or an ethics committee is specified as the contact point for employees who wish to report concerns about unethical or illegal behaviour that might also compromise the integrity of financial statements.

the hierarchical structure of firms that would make inappropriate a power to monitor, conferred to the lower echelon in relation to upper echelons. However, there are exceptions concerning those areas, specifically directed at monitoring. Recent scandals have shown the importance of the role played by internal auditors and in-house lawyers towards members of the board or managers enjoying relatively strong decision-making power. In relation to these areas, it is normal that employees or managers in lower positions observe and sometime monitor upper-level decision-makers and even members of the board.

New regulations have been enacted on both sides of the Atlantic to empower these functions and to protect internal officers. In both cases, the question of whether professional self-regulation should regulate these matters instead of legislation is an open issue.[111] Here the internal-external divide is complemented by the different regulatory sources, particularly in statutory law and codes of conduct.

To consider the bottom-up dimension of the loyalty chain, one should focus on those employees or managers whose main function is not monitoring, as might be the case for auditing officers, but other functions that may incidentally or intentionally involve some level of loyalty monitoring. A complementary system that often implies monitoring of lower-level employees is that of auditing officers or those in charge of internal control.

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111 In relation to the U.S. experience concerning lawyers, see the Sarbanes-Oxley Act, *supra* note 7, § 307:

> Attorneys representing public corporations before the Securities and Exchange Commission are required to report evidence of material violations of securities laws and breaches of fiduciary duty to the chief legal counsel or chief executive officer. If following such a report the officers do not appropriately respond, an attorney must submit the evidence to the audit committee or to the board of directors.

On these issues, see Deborah L. Rhode & Paul D. Patton, *Lawyers, Ethics and Enron*, 8 Stan. J.L. Bus. & Fin. 9, 32 (2002):

> The problems of maintaining independence are especially challenging for in-house counsel who generally face the greatest pressures to maintain group solidarity. For law-firms, walking away from major clients can result in significant financial losses; for in-house counsel it can be devastating: The general counsel office places lawyers in the position of "maximum information, maximum responsibility and minimum job security." Rules requiring corporate lawyers to report corporate fraud can provide much needed support for these who would otherwise face enormous pressure to remain team players. The Sarbanes-Oxley legislation is thus a step in the right direction. As noted it requires lawyers to go on up the chain of command with evidence of material violation of securities law or breach of fiduciary duty.

Given their position within the organization, these employees are protected by special rules that should prevent managers and directors from being able to threaten retaliation. In other words, it may occur that an auditing officer is called upon to monitor the conduct of parties located in the upper levels of the organization. But, since that is their exclusive task, they are given organizational protection that differs from those for whom vertical monitoring may be incidental to the tasks they perform.

Lower-level members of the organizations are given mainly incentives to reveal violations of the duties of loyalty and are protected against possible retaliation if they refuse to violate their duties of loyalty (so called whistleblower statutes).[112] Rights may either be specifically aimed at protecting employees who expose violations or may arise out of civil or fundamental rights in the workplace.[113] For example, freedom of speech or freedom of expression has been used to protect employees or managers from unlawful dismissal due to severe criticism directed at the board of directors.

From this perspective, to define rules concerning internal transparency, accessibility to documents, and participatory decision-making procedures

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112 See, for example, the so-called whistleblower statutes that ensure the employee the right to be compensated and reinstated if unlawfully fired and to have criminal or civil violations disclosed. *See* Sarbanes-Oxley Act, *supra* note 7, § 806(a):

> No company with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l), or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(d)), or any officer, employee, contractor, subcontractor, or agent of such company, may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee (1) to provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct which the employee reasonably believes constitutes a violation of section 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders, when the information or assistance is provided to or the investigation is conducted by (A) a Federal regulatory or law enforcement agency; (B) any Member of Congress or any committee of Congress; or (C) a person with supervisory authority over the employee (or such other person working for the employer who has the authority to investigate, discover, or terminate misconduct); or (2) to file, cause to be filed, testify, participate in, or otherwise assist in a proceeding filed or about to be filed (with any knowledge of the employer) relating to an alleged violation of section 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders.

113 Within the first category are, for example, the so-called whistleblower statutes in the U.S both at state and federal levels.

may improve the function of indirect control at the lower level regarding the loyalty of the upper level. An increase in the circulation of information within the organization may presuppose stronger safeguards against the danger of spill-over. The confidentiality agreement regulations should be revised in order to redefine the boundaries concerning circulation of information within the organization and between the organization and the external world.

In a pure hierarchical organization in which monitoring is identified with control, the bottom-up chain would be nonsensical. In organizations whose "sovereignty" is fragmented, standard-setting and monitoring tend to become reflexive processes; where some negotiation or mediation takes place, the growing importance of the bottom-up dimension has to be acknowledged. This recognition leads to the necessity of considering the modes of integration between horizontal and vertical dimensions of monitoring, its implications on governance design, and its influence on the standards of the duty of loyalty.

VIII. INTEGRATING HORIZONTAL AND VERTICAL MONITORING FOR GOVERNANCE DESIGN AND FOR STANDARDS OF LOYALTY PURPOSES

The two vertical chains and the auditing and internal control functions should, therefore, be seen contextually as a matter of governance and as a matter of standards affecting organizational loyalty. Though they are not often intentionally designed to define an overall system of internal organizational loyalty, they turn out to be quite mutually self-reinforcing. When organizations define their compliance programs, this interplay should be given much more attention than is currently provided.

What are the implications of considering the horizontal and the vertical dimensions of organizational loyalty? We can distinguish at least two possible different implications:

1) In terms of governance design: when compliance or internal control programs are designed to promote organizational loyalty, their efficacy may be improved by considering the fact that the standard-setters and private enforcers, located at the highest or intermediate level of the organizational hierarchy, are subject to control both from shareholders and from the lower level, as well as from external stakeholders, such as creditors. Furthermore the consideration of different levels may affect the modes of peer monitoring taking place within the board. The duty and power of independent directors to acquire information concerning the activities of executive directors may only be operationalized by rendering the overall organization more responsive.

2) In terms of interplay with the duties of loyalty: Should the existence of

the described vertical dimensions of loyalty affect the variables influencing the choice among prohibitory, authorization-based, and compensatory rules and the associated standards? I have mentioned that historically, in company law, there has been a move from prohibitory to authorization-based or compensatory rules. The latter two are certainly more consistent with a higher level of discretionary power of directors. The effort towards independence has proved to be quite ineffective as a governance mechanism to enable the adoption of compensatory rules instead of prohibitory ones. Recent scandals have again posed the question concerning the opportunity to reduce organizational and, in particular, boards' discretion to reintroduce prohibitory rules. The policy alternatives can be roughly summarized as follows: a move back to prohibitory rules or a reinforcement of the governance design to enable the control of a higher discretionary power.

fore the solution should be to strengthen the governance system by considering how the vertical dimensions of loyalty can support the use of authorization-based rules or compensatory rules, even for directors, without moving back to prohibitory rules. While independence may be helpful, it is desirable to increase the use of information flow and transparency, thereby reducing the tendency to appropriate information within the organization. Internal, though protected circulation of information may foster organizational loyalty. Furthermore, if bottom-up monitoring were more effective, more effective control would be ensured.

IX. NETWORKS OF FIRMS: THE DIFFERENT SPACE OF LOYALTY AND CONFLICTS OF INTEREST IN REDRAFTED ORGANIZATIONAL BOUNDARIES

The model of organizational loyalty just described fits quite well with hierarchically organized economic activities.[114] Its heuristic power and legal efficacy diminish in relation to different models of firms where production is decentralized and organized around teams endowed with a high level of economic and legal autonomy (for example, where units have the power to transact with third parties, have a certain degree of budgetary independence, etc.). I am referring specifically to networks of small— and medium-sized enterprises.[115] In these organizations, each team is contractually

114 Here the reference is not to traditional hierarchy but to a revised hierarchical structure that incorporates reflexive processes of learning about conduct that may affect organizational loyalty.

115 On the debate concerning different models of firms, see Anna Grandori & Giuseppe

responsible towards the other teams and the organization of the network as a whole. This kind of organization is also characterized by different legal boundaries.[116] Often teams may be organized in units with their own legal personality. Duties of loyalty among entities with a legal personality pose somewhat different problems both for vertically integrated organizations and for bilateral contractual relations between individuals.[117] If the level of resource interdependence is high, despite legal boundaries, organizational loyalty should encompass different firms. In the latter case, duties of loyalty may be owed by each firm to the others belonging to the network.

The existence of a network of firms implies that some of the issues of loyalty, previously defined as internal organizational problems, become inter-organizational. The question is whether the presence of a relevant inter-organizational dimension bears some effect on the legal instruments concerning loyalty, in relation to both governance and duties.

According to the definition of loyalty used above, whereby loyalty ensures a legal entitlement to trust, since networks of small firms are characterized by the existence of collective trust as a crucial common resource, loyalty should not only protect intra-organizational trust but also inter-organizational trust.[118] When the network is formalized, through the creation of a consortium (for example, an association, a corporation, a foundation), members of the network, firms, and their directors may owe a duty of loyalty to the organized

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Soda, *Inter-Firm Networks: Antecedents, Mechanism and Forms*, 16 Org. Stud. 183, 183-214 (1995); Walter W. Powell, *Inter-organizational Collaboration in the Biotechnology Industry*, 152 J. Inst. Theoretical Econ. 197 (1996); Oliver E. Williamson, The Mechanism of Governance (1996); Ranjay Gulati, *Alliances and Networks*, 19 Strategic Mgmt. J. 293 (1998); Ranjay Gulati et al., *Strategic Networks*, 21 Strategic Mgmt. J. 203 (2000); Bruce Kogut, *The Network as Knowledge: Generative Rules and the Emergence of Structure*, 21 Strategic Mgmt. J. 405 (2000).

116 The problem of boundaries of the firm has been at the core of recent debate in the economic literature and has already had important repercussions in the legal debate. *See* Bengt Holmstrom & John Roberts, *The Boundaries of the Firm Revisited*, 12 J. Econ. Persp. 73 (1998); Oliver E. Williamson, Examining Economic Organization Through the Lens of Contract (2002); Henry Hansmann, *What Determines Firm Boundaries in Biotech?*, 152 J. Inst. Theoretical Econ. 220 (1996) (with reference to inter-firm networks).

117 *See* Fabrizio Cafaggi, *Fiduciary Duties, Models of Firms and Organizational Theories in the Context of Relational Interdependencies*, *in* Legal Orderings and Economic Institutions (Fabrizio Cafaggi et al. eds., 2004).

118 *See* Susan Helper & Mari Sako, *Determinants of Trust in Supplier Relations: Evidence from the Automotive Industry in Japan and the United States*, 34 J. Econ. Behav. Org. 387 (1998).

network in addition to reciprocal duties.[119] In this case there is a clear difference between legal instruments aimed at protecting individual organizational trust and legal instruments aimed at protecting collective trust.

When the network is not formalized, i.e., does not exist as a legal entity that reunites all the members, then the collective dimension of loyalty is more difficult to translate into legal instruments. When a governance aspect in legal terms does not exist; what is then left is the duty dimension. Here two changes with respect to the hierarchical model are needed:

1) the possibility that duties of loyalty can be owed to other firms participating in the network, to capture an inter-organizational dimension beyond the traditional intra-organizational one; and

2) the idea that duties of loyalty owed to another firm may not only reflect the bilateral relationship between the two firms but may also protect the collective dimension of trust, even if a collective legal entity does not exist.

The traditional juxtaposition between loyalty and fair dealing, which roughly summarizes the two types of relationship (organizational and contractual), needs to be rethought in light of these relational contracting models.

Duties of loyalty, in the context of small firm networks, are more reciprocal, as in the joint ventures and partnership scenarios, than they are in the hierarchical model of the publicly owned corporation.[120] The same is true of conflicts of interest.[121] The main difference with the partnership

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119 *See* Cafaggi, *supra* note 117.

120 In the U.S., the principle was stated in *Meinard v. Salmon*. *See also* Fouchek v. Janicek, 225 P.2d 783 (Or. 1950) ("Joint venturers like co-partners, owe to one another, while the enterprise continues, duty of finest loyalty, and as trustees are held to something stricter than morals of market place, and not honesty alone, but the punctilio of an honor the most sensitive is then the standard of behavior."); Sheppard v. Carey, 254 A.2d 260 (Del. Ch. 1969) ("Joint venturers were under fiduciary relationship which imposed upon them utmost good faith, fairness and honesty in dealing with each other with respect to joint venture."); Skone v. Quanco Farms, 68 Cal. Rptr. 780 (Cal. Ct. App. 1968) ("Fiduciary duty between partners or joint venturers is rule of ethics and fairness and is essentially similar to duty owed by agent to his principal or by trustee to his cestui que trust."); Jaffe v. Heffner, 343 P.2d 374 (Cal. Ct. App. 1959) ("The title of a joint venturer in joint venture assets is that of beneficiary of a constructive trust, and a joint venturer holding or acquiring title to property for a joint venturer is a trustee for his co-venturers, even though he buys and pays for the property with his own funds."). For a comparison with contractual regimes, see Universal Builder Supply Inc. v. Shaler Highlands Corp., 186 A.2d 30 (Pa. 1962) ("A joint venturer owes to a co-venturer a higher degree of faith than that which exists in a creditor-debtor relationship.").

121 Again, I am referring not to the legal regulation of conflicts of interest but to the substantive phenomenon of conflicts of interest in networked firms or in networks

or joint venture models is that here an external dimension is added. The governance system should reflect, in relation to organizational loyalty, the fact that relevant relationships are also those concerning suppliers, customers, financers, and the firm. This reciprocity implies that the creation of mutual monitoring is more difficult to govern than that of large companies, where there is a prevailing vertical loyalty chain, with principal monitoring agents acting on behalf of the organization down the chain.[122]

I would now like to provide a more concrete analysis to show why organizational loyalty works differently and should be accordingly defined when firms are (1) smaller and (2) organized into networks.

Smaller firms generally present a more homogenous ownership structure and a less clear-cut distinction between directors and management — in other words, between corporate policymaking and implementation. For example, in relation to partnerships, the key distinction is between managing and non-managing partners. In smaller firms, ownership is concentrated and agency costs are related to the difference between managing and non-managing, rather than to that between owners and managers.

Whether a supplier, customer, or a legal counsel is a minority shareholder or sits on the board, it should be relatively important to include them within the loyalty system and to apply conflict of interest rules. The application of the duty of loyalty regime to include these stakeholders should not depend on the fact that they participate as shareholders (or directors) of the firm. They might have a limited portion of shares or even none, but still play a key role in the governance system of the firm and the network.[123] Their loyalty towards the firm and its shareholders may be as relevant, or even more relevant, as that of directors. The applicable legal regime should therefore not be based on the distinction between customers, suppliers, financers, or lawyers who are shareholders and/or directors sitting on the board and those who simply have a contractual relationship with the firm, who have minor loyalty obligations. The system of organizational loyalty should encompass all of them. They ought to owe a duty of loyalty to the firm and to the network (when formalized in a consortium or an association), as well as to directors, managers, and employees in vertically integrated firms. The internal-external divide may

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of firms. On the issue of conflicts of interest in networks of firms, see Fabrizio Cafaggi, *Il Governo Della Rete*, *in* Reti di Imprese Tra Regolazione e Norme Sociali (Fabrizio Cafaggi ed., 2004).

122 On monitoring systems in manufacturing industry networks, see Susan Helper et al., *Pragmatic Collaborations: Advancing Knowledge While Controlling Opportunism*, 9 Ind. Corp. Ch. 443 (2000).

123 *See id.*

reflect upon the legal instrument used to ensure compliance with principles of organizational loyalty. Different coordination devices concerning loyalty are needed depending on whether only company law standards are used or if labor law, consumer law, and contract law are also used, along with company law, to foster loyalty and prevent conflicts of interest.

The need to vary in approach emerges in relation to the combination of standards of loyalty and governance design. When firms are smaller, suppliers, customers, and consultants (lawyers, accountants) often all sit on the board of directors. Interested parties are therefore involved in the decision-making processes. This involvement might appear to be a way to institutionalize conflicts of interest. But it does not. In this context, often these privileged relationships with suppliers, customers, legal counsel, and accounting firms precede participation in the governance structure. For suppliers, customers, or legal counsel to become members of the board entails recognition of their close relationship with the firm, rather than a way to enable these partners to unlawfully benefit from their posts. To have privileged relationships in this context by non-independent directors does not pose the same problems as in the context of publicly owned corporations, because they are not aimed at benefiting directors and managers and harming shareholders in general or minority shareholders. This difference is relevant for small enterprises, but it becomes crucial when they operate within networks.

To have parties sitting on the board who are privileged business partners may also undermine the requirement of independence. Certainly these parties are interested and not independent. In theory, then, this practice would violate the principle of independence stated both in legal norms and codes of conducts for publicly owned corporations. However, there is reason to believe that the move towards independence as a fundamental ingredient of organizational loyalty and as deterrent to conflicts of interest, which has taken place in public corporations, should not be the key factor in networks of firms. While it is important to have duties of loyalty between shareholders and directors, independence cannot be the key to ensure that duties of loyalty are complied with in networks of firms. On the contrary, dependence and interdependence of firms and, to some extent, of their managers are resources and assets to produce trust and social capital and to reduce transaction costs. Firm interdependence or network interdependence has to have some effect on organizational design aimed at ensuring intra-network loyalty. Duties of loyalty should therefore be directed at preserving interdependence of resources.

To apply the same above outlined legal and ethical criteria concerning independence to these firms would add no benefit and would only produce

harm by reducing the opportunity to reinforce interdependence. The different sizes of the firms, the fact that they operate within a network, and, most importantly, their different boundaries all work to move the loyalty frontier from within to outside the firm, adding a new dimension to the flow of organizational loyalty: the inter-organizational dimension. The additional unity of analysis to identify the legal regime of loyalty and conflicts of interest becomes the network. Internal organizational loyalty remains an important feature but it must be combined with loyalty towards formally external firms and, in particular, loyalty within the network and among firms and stakeholders participating in the networks.[124]

To what extent do legal systems reflect these changes and regulate loyalty and conflicts of interest accordingly? In many legal systems, the reduced dimension of the firm and the closeness or coincidence of shareholders, directors, and managers induce stress on the reciprocity dimension of both loyalty and conflicts of interest, which, in turn, translate into systems of peer monitoring. Often, but not always, stricter standards of conduct are adopted. While it is clear that vertical monitoring should play a much less relevant role in these organizations, there is no reason to *a priori* adopt stricter standards in smaller firms. If the focus is on the interaction between governance and the duty dimension, the challenge is to define governance mechanisms that can ensure as much discretion as is needed in larger vertically integrated firms.

A separate but connected problem is the relationship firms have with other firms in the network. Both the empirical and the theoretical literature have shown that in networks most of the time firms can be competitors and cooperators at the same time.[125] They can cooperate to produce something and compete to sell something else. While in the world of big corporations, cooperation and competition are generally more easily distinguishable and this brighter distinction translates into duties of loyalty that differ accordingly, when firms operate in a network, the loyalty dimension is manifested in the ability to preserve the right balance of competition and cooperation.[126] Suppliers may owe a duty of loyalty and be forbidden to conclude transactions

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124 An issue of loyalty may arise in relation to the local bank that finances many of the firms in the network, towards trade unions or towards external suppliers of the network.

125 *See* Walter W. Powell & Laurel Smith Doerr, *Networks and Economic Life*, *in* Handbook on Economic Sociology 368 (Neil Smelser & Richard Swedberg eds., 1994). *See also* M. Porter, On Competition (1998).

126 *See* Porter, *supra* note 125. For the analysis concerning industrial districts, see Giacomo Becattini et al., From Industrial Districts to Local Developments (2003); for a general approach from a legal perspective concerning tensions and interaction

with other firms through supply contracts, mimicking the same regime that would have been achieved by applying prohibitory rules if the supplier had also been a director sitting on the board. Alternatively, following the tripartite structure of rules concerning duties of loyalty, they should ask for some approval or compensate if the transaction constitutes disloyal behavior. Criteria concerning transactions both within and outside the network can be *ex ante* defined in the contract, or if it is preferable to have some discretion, a procedural safeguard could be devised to preserve loyalty. Likewise, customers operating within the network may have loyalty obligations towards suppliers that arise out of their contract.

This already occurs in different forms. Some of these aspects are captured by covenants not to compete, but they should be rethought in the context of a more comprehensive network loyalty system. What I advocate is that a relatively homogeneous principle of conflict of interest be applied to firms operating in networks, regardless of whether they formally participate in the internal organization of the firm or are simply linked through contracts but clearly belong to the network, either because it is formalized or because it emerges from a consistent number of contractual relationships among firms.[127]

This paper is not concerned with the better legal device, i.e., whether these should be fiduciary duties based on company law or duties based on contract law, but it is clear that there is a more general dimension of loyalty as a consequence of the new and different boundaries of firms generated by the network. This change is even more radical when there is a full overlap between shareholders, board, and management, i.e., where the same people are at the same time shareholders, directors, and managers. In such a case, there is certainly an internal dimension concerning reciprocal duties of loyalty among the members of the organization. However, the external dimension ends up playing an even stronger role.

Two relevant dimensions concerning loyalty and conflicts of interest should be underlined in networks of small firms: 1) the exit frontier of duties of loyalty moves in part from the firm to the network; and 2) internal and external dimensions of loyalty and conflict of interest coexist, and the content of the rules should reflect the need for such a combination in the context of relationships characterized by competition and cooperation. On the one hand, this shows the necessity outlined earlier to analyze duties

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between rules aimed at fostering cooperation and rules aimed at guaranteeing competition, see Cafaggi, *supra* note 121.

127 To implement this principle is certainly easier when the network is formalized, while where no formal legal entity exists, the existence and operation of a duty of loyalty may be more difficult to prove.

of loyalty and related standards in relation to the governance design they operate within. On the other hand, it poses the problem of distinguishing legal sources concerning regulation of organizational loyalty by combining corporate law, labor law, and contract law.

PRELIMINARY CONCLUDING REMARKS

The importance of organizational design to prevent corporate misconduct has become more and more important over the last fifteen years, and yet the main implications for the definition of organizational loyalty and correlated standards have not been fully considered.

This paper has tried to show that the aim of preserving organizational loyalty in firms, rendered even more compelling by recent scandals, should be based on a complex strategy that considers the governance design within which standards of duties of loyalty should be defined. The first and probably principle argument of the paper is that loyalty has different characteristics in vertically integrated firms and in networks of small firms. Current legal regimes do not sufficiently acknowledge these differences, especially those associated with different legal and economic boundaries and those related to different models of work organization. More research is needed to define the legal features of loyalty in networks of firms.

The second point is related to the different dimensions that affect organizational loyalty, focusing on the interaction between the horizontal and vertical dimensions and the consequences in terms of governance and standards that this interaction may have. It is developed more in relation to hierarchical firms, but it plays some role in networks as well. The interdependence between governance and standards of duties should not make mandatory duties of loyalty and conflicts of interest rules dependent upon the organizational choices. But given a certain level of desired loyalty, the way it should be rendered operational ought to be correlated with the governance design.

The paper proposes a distinction between horizontal and vertical dimensions of loyalty, particularly referring to monitoring aspects as affecting governance design. This geometry reflects an allocation of hierarchical power, but it also exemplifies the illustration of different flows of duties within the firm and, to a limited extent, towards external stakeholders. The choice of rules concerning loyalty and conflicts of interest in particular, which are classified as prohibitory, authorization-based, and compensatory, should be affected by the efficacy of both peer monitoring and hierarchical monitoring, something that is difficult to encapsulate in the traditional agency model.