

# Artificial Intelligence Intervention in Corporate Governance: Directors' Fiduciary Duties

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## Abstract:

The increasing use of commercial artificial intelligence technology in corporate governance poses potential legal risks. This paper analyses the intervention of artificial intelligence in corporate governance from the perspective of directors' fiduciary duty, discusses its impact on directors' duty of loyalty and care, and points out that the use of artificial intelligence itself is in line with the requirements of the current legal system on directors' fiduciary duty, but may increase the directors' care duty, especially in terms of overseeing the process of the use of artificial intelligence. Based on this, the paper makes recommendations for the improvement of Company Law and internal corporate governance.

**Keywords:** Artificial Intelligence, Corporate Governance, Directors' Duty of Fiduciary, Directors' Duty of Loyalty, Directors' Duty of Care

## I. Introduction

With the rapid development of AI technology, business-orientated weak AI<sup>1</sup> The large models exemplified by ChatGPT are rapidly growing. Many companies have started to adopt AI to assist corporate governance. Directors, supervisors, and senior managers of companies adopt AI technology to assist in internal management, business decision-making, and other tasks.<sup>2</sup>, which significantly liberates productivity but may also bring potential legal risks. Currently, there are few studies on AI in company law, and studies focusing on the individual level are even more scarce. This study hopes to analyze the directors' fiduciary duty from the perspective of one of the core rules of the legal system of company law and to study the changes that will happen to the directors' fiduciary duty when AI intervenes in corporate governance in the era of artificial intelligence.

With respect to the duties and responsibilities of directors, the current Company Law of China (hereinafter referred to as the 'Company Law') provides that such persons shall have the duty of loyalty and care to the Company (*Article 147 of the Company Law of the People's Republic of China*: directors, supervisors and senior management shall abide by the laws, administrative regulations and the articles of association of the company, and shall have a duty of loyalty and care to the company. Directors, supervisors, and senior management shall not use their authority to accept bribes or other illegal income and shall not misappropriate the company's property.<sup>3</sup>). The revised *Compa-*

*ny Law of 2023* (not yet in force) has further refined the content of the duties of loyalty and care undertaken by directors, supervisors, and senior management (*Company Law of the People's Republic of China [as amended in 2023] Article 180*: Directors, supervisors and senior management have a duty of fidelity to the company, shall take measures to avoid conflicts between their interests and the interests of the company, and shall not use their authority to gain undue advantage. Directors, supervisors, and senior management have a duty of care to the company, and in the performance of their duties, they shall exercise the reasonable care normally expected of a manager in the best interests of the company.<sup>4</sup>). The Supreme People's Court of the People's Republic of China held that the duty of loyalty means that a director of a company shall faithfully perform his duties. In the event of a conflict between his interests and the interests of the company, he shall safeguard the interests of the company. He shall not make use of his position as a director to sacrifice the interests of the company for his own or a third party's profit. Duty of care means that a director of a company shall perform his or her duties with the care of a good manager and with the reasonable care of a person of ordinary prudence for the best interests of the company.<sup>5</sup> Mr Justice Foster in the UK stated that company directors have a duty to act in good faith and the interests of the company (see *Section 172 of the UK Companies Act 2006*). They must also show such skill and care as can reasonably be expected from their knowledge and experience.<sup>6</sup> *The New York State Corpo-*

*rations Law* provides that the officers of a company shall perform their duties as officers in good faith and with the degree of care that an ordinarily prudent person in a like position) would exercise.<sup>7</sup> A director shall perform his or her duties as a director, including the duties of any member of the board of directors of which he or she may be a member, in good faith and with the degree of care that an ordinarily prudent person in a like position would exercise under similar circumstances.<sup>8</sup>

## II. Directors' fiduciary duties when AI is involved in corporate governance

As an independent legal entity, the company has independent property, civil rights, and civil capacity. In normal operation, the company is responsible to its shareholders. The core of modern company law is established and shaped by the agency cost system.<sup>9</sup> The modern corporation is characterized by the separation of ownership and control, where the owners of the corporation do not control the corporation, and the controllers of the corporation do not own the corporation. It is this situation that makes the company controller (operator) speculate, make personal profit, and abuse the company control authority for their interests. Therefore, academia expects to limit and regulate the authority of the company controller and reduce agency costs by constructing a system for directors' duties and agency participation rights.<sup>10</sup> In judicial practice, the company law is the core of the legal system to reduce agency costs, which is the core idea that was born.<sup>11</sup> Some scholars envision that when artificial intelligence becomes a company director, the traditional theory of agency cost will not be applicable before artificial intelligence due to the impossibility of the artificial intelligence itself engaging in private fraud and public enrichment.<sup>12</sup> In the author's view, before the creation of strong AI, we should also consider how to confirm whether AI can assist company directors, supervisors, and senior management in corporate governance under the agency cost system and confirm the limits of directors not to violate fiduciary duties. For this analysis, it is important to focus on reducing the total agency costs of combining boards of directors, supervisory boards, and senior managers with corporate control and analyze the individual fiduciary duties of directors with the involvement of AI. The following discussion of this fiduciary duty is developed in two parts: whether the use of AI by directors to assist in corporate governance complies with the requirements of the fiduciary duty under the current legal system and how the fiduciary duty of directors will change when AI becomes involved in corporate governance.

### (i) Directors' use of AI to assist corporate gov-

### ernance is consistent with the requirements of the duty of care under the current legal system

The United Kingdom and the United States have a relatively perfect standard for reviewing the duty of care, and the relevant provisions in China have also been developed. We can see that, although there are some differences in the provisions of the three countries, to judge whether the director has "good faith" as the standard, the basic review benchmark in practice is whether the director is performing his duties with gross negligence (requiring a heavier positive burden of proof), that is, to examine whether he has reached the level of care that would be prudent for an ordinary person of the same status.<sup>13</sup> In what follows, we will use this standard to determine whether a director has breached the duty of care in a particular situation.

The precise meaning of the duty of loyalty in US corporate law is that directors and officers of a company must not use the company or the resources of their co-investors for personal gain. According to some scholars, the structure of US case law in determining the breach of the duty of loyalty by directors is as follows: first, whether there is an interest; second, whether the transaction is appropriate; third, whether there is a reasonable procedural act to approve the transaction; and fourth, if there is such a procedural act, whether it can exempt the director from liability.<sup>14</sup> In view of the fact that the standards for judging the director's duty of loyalty are not clear in the current practice of Chinese company law, the following discussion will refer to the above standards.

As for the distinction between the duty of loyalty and the duty of care, the High People's Court of Beijing Municipality has pointed out in the case that the duty of care is a kind of positive obligation of action... in most cases, it precisely embodies the negligent duty of omission.<sup>15</sup> In the author's view, generally speaking, the duty of loyalty is a kind of obligation of omission, while the duty of care is a kind of positive obligation of action.

The director's use of AI to assist in corporate governance meets the requirements of the duty of fidelity under the current legal system. For the following, "the use of AI by directors to assist in corporate governance" will refer to the act itself of introducing AI into corporate governance by directors in good faith. In the following section, the duty of good faith will be divided into the duty of loyalty and the duty of care.

First is the duty of loyalty. As mentioned earlier, the first element for finding a director's breach of the duty of fidelity is the existence of an interest in the transaction.<sup>7</sup> Obviously, only considering the condition of using AI to assist in corporate governance does not satisfy the element that

there is an interest in the transaction, and the director's use of AI to assist in corporate governance meets the requirements of the duty of fidelity.

Second, the duty of care. It was pointed out earlier that the determination of whether a director has fulfilled the duty of care should examine whether the director acted in good faith and with a degree of care that would be prudent for an ordinary person of equal status.<sup>13</sup> Currently, there are numerous examples of commercial AI applications, and AI has been used as a common tool to enter into the vision of managers.<sup>16</sup> In most examples, the introduction of AI into corporate governance is an act that can enhance the efficiency of internal management. Therefore, it is generally accepted that a director's use of AI to assist in corporate governance is in good faith (unless there is clear evidence that the director has introduced AI for the purpose of harming the company's interests or avoiding his or her duties) and that it is a choice that an ordinary person of the same position would make in a prudent situation. Therefore, the directors' use of AI to aid corporate governance meets the requirements of the duty of care.

In summary, the directors' use of AI to assist in corporate governance meets the requirements of the duty of care under the current legal system. With this conclusion, it is possible to move on to the next step, which is a discussion of whether there is a change in directors' fiduciary duties under AI-assisted corporate governance.

### **(ii) When AI intervenes in corporate governance, the directors' fiduciary duties will change to some extent**

Corporate governance with AI intervention is a more complex structure than usual corporate governance, so AI intervention does not reduce the original fiduciary duty requirements of directors. Therefore, in the following, we will focus on whether the intervention of AI will add additional requirements to the directors' fiduciary duties. To carry out this analysis, it is necessary to first analyze the legislative purpose of the directors' duty and the interests that the directors' duty should protect, and secondly, it should analyze whether the existing provisions on the directors' duty can satisfy both of the above requirements. In the following section, an analysis will be made in the direction of the duty of loyalty and the direction of the duty of care.

Firstly, the duty of loyalty. The directors' duty of fidelity does not increase due to the intervention of AI. The so-called duty of fidelity means that a director shall not make use of the facilities brought by his/her authority to benefit himself/herself or a third person. In terms of the legislative purpose, the duty of fidelity is set up to protect the owners of the company (shareholders) from intentional

infringement of their rights and interests in the fiduciary relationship by the trustee. This director actually holds the management and control of the company, and it is set up to reduce the cost of agency of the company. It is a foundational duty created to protect the interests of shareholders.<sup>17</sup> From the perspective of the interests protected by the law, the director's duty of fidelity provision protects the independent personality of the company's legal person, property rights, and the property rights and interests of the company's owners (shareholders).

Under the new scenario of AI intervention in corporate governance, directors' behavior to harm the interests of the company and shareholders and to use publicity for private gain may take the following new forms. First, in the process of selecting AI, participating directors may choose AI service providers with which they have interests, forming self-dealing or conflicting dealings; second, company directors may use AI as a tool or take advantage of the facilities brought by AI to infringe upon the company's commercial secrets, harming the company's interests and profiting for their interests. Obviously, all of the above issues are encompassed by the director's duty of loyalty.

When AI intervenes in corporate governance, the legislative purpose of the director's duty of fidelity and the interests to be protected have not changed. The possible offenses have been encompassed by the provisions of the duty of fidelity, so the intervention of AI in corporate governance will not change the requirements of the director's duty of fidelity.

Second, the duty of care: the director's duty of care will indeed increase due to the intervention of artificial intelligence. The so-called duty of care means that a director should exercise the degree of care that would normally be exercised by a person of his or her equal status. Its legislative purpose and the interests protected by law are broadly the same as the duty of loyalty. The difference is that the duty of care is to protect the interests of the owners of the company from being infringed by the directors by way of inaction or imprudent action.

Judging whether directors have fully fulfilled the duty of care in the new scenario of AI intervention should be analyzed from the following perspectives. Firstly, the behavior of company directors in applying AI to assist their work should be in good faith. The determination of whether this behavior is in good faith should be based on the purpose of applying AI, i.e., the director should apply AI with the purpose of improving the efficiency of the work, for the purpose of maintaining and enhancing the interests of the company and being responsible for the company and the shareholders of the company. Secondly, reference should be made to the analytical structure of directors' supervisory obligations in the United States.

The first view is that the director's supervisory duty carries a passive nature, which is the minimum requirement of the director's supervisory duty, and the director does not have an active duty of action to check whether there is any non-compliance with the company's regulations and laws and regulations. The director's duty of supervisory duty exists as an action only when the non-compliance of the subordinate is actively demonstrated in front of the director.<sup>18</sup> For this view, the corresponding construction of the duty of care when AI intervenes in corporate governance is discussed below; the director does not have the duty of supervision as an action for the AI governance in the company; the director does not need to take the initiative to supervise the other directors to see if there is any misuse of the AI and whether there is any misuse of the AI in the process of the company's execution. The director will be liable for the duty of supervision as an action only when the director knows or ought to know that there is misuse of AI in a certain level of the company. It is only when the director knows or should know that there is an abuse of AI at a certain level of the company that the director has an active duty to supervise.

The second view is that a director's duty to supervise should include (1) endeavoring to ensure the existence of a proper system for collecting and reporting information within the company (the first element) and (2) only if the board of directors persistently or systematically neglects to supervise, for example, by failing to make any attempt at all to ensure that a reasonable system of information collection and reporting exists, will a lack of good faith be regarded as a breach of the duty to supervise (the second element), which may be established by the board's duty to supervise. The possibility of establishing a breach of a director's duty to supervise (second element).<sup>19</sup> In response to this view, the duty of care when AI intervenes in corporate governance, is constructed accordingly, as discussed below. Given the high potential and risk of abuse of AI in corporate governance, directors in large companies have a duty to engage in a dialogue about the construction of a supervision system for the use of AI in the company. Still, the subject of the obligation to construct it should be the board of directors. Suppose the board of directors is negligent in fulfilling its obligation to construct the monitoring system. In that case, the subject of the monitoring obligation is transferred from the board of directors to the directors. Each director has the basic obligation to actively monitor the use of AI within the company, which as an as-obligation adds a part of the director's duty of care.

Both views have merit. In support of the first view, it is argued that company directors may not have expertise in AI oversight, that forcing the obligation to oversee AI use on directors will not help reduce agency costs, and that direc-

tors who are not AI professionals are likely to be unaware of how to fulfill the obligation to oversee AI. In support of the second view, it is argued that there is a The second view is supported by the fact that AI has a great risk of abuse in corporate governance. It is important to clarify the responsible parties for AI governance oversight, which directors happen to have. According to this way of responsibility clarification, the probability of AI abuse by decision-makers and management will be greatly reduced, and even if AI is abused, the responsible supervisory subject directors can be held accountable, so the agency cost of the company can be reduced.

In addition, directors should follow the requirements similar to the "red flags" standard in the review of directors' supervisory duties in the United States.<sup>20</sup>, i.e., in the process of corporate governance, if the directors are aware of the red flags (red flags) but do not take measures to respond to them, such as investigating, supervising, and making improvements, the directors will be liable for their supervisory failures. Responsibility for their supervisory failures. When AI intervenes in corporate governance, directors should be more prudent in supervising activities involving AI in the company and actively fulfill their supervisory obligations.

In summary, when AI intervenes in corporate governance, the legislative purpose of the directors' duty of care and the interests to be protected remain unchanged. Still, the two requirements, i.e. bring about an increase in the duty of care, the directors have more obligations of action with regard to the duty of care, including the possible supervision of the use of AI and the necessary ways of responding to the "red-flag signals". And the manner in which they must respond to "red flag signals". Therefore, the involvement of AI in corporate governance may increase directors' duty of care requirements.

### III. Recommendations

#### (i) Improving the Provisions of Company Law on the Duty of Faithfulness and Care

The provisions of China's company law on the duty of loyalty and care of directors, supervisors, and senior management personnel are still not exhaustive, especially the provisions on the duty of care. The legislator should study the provisions of other countries with better legislation on directors' duty of fidelity and further improve the provisions of our company law on the duty of fidelity so as to make progress in the scientific and uniformity of the relevant commercial litigation decisions, and to appropriately limit the judge's discretionary power. Company law in the study and revision should also focus on the agency cost system as the core of the analysis of the modern company

system under the theoretical structure to make further scientific adjustments.

### **(ii) Companies should improve their internal systems**

The company law leaves a great deal of autonomy for the company's internal governance. The company mainly exercises its autonomy through the provisions of the articles of association and internal rules and regulations to enhance the efficiency and compliance of internal governance. Therefore, the company may design a suitable internal monitoring system under the Company Law system to further clarify the requirements for the application of AI in the governance of the Company, as well as the requirements for the directors and other senior management in the execution of the Company's affairs, to advance the development of the Company's compliance level and to promote the sustainable development of the Company's governance.

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