OFFICERS' FIDUCIARY DUTIES AND THE NATURE OF CORPORATE ORGANS

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The nature of officers' fiduciary duties (and in particular whether the Business Judgment Rule applies to officers) is the subject of heated scholarly debate and conflicting case law. This Article analyzes the question using a neglected conceptual tool: the corporate organ.

Corporate organs are bodies that act on behalf of the corporation but are not subject to its control and thus are not governed by agency law (the board of directors is the prototypical organ). This Article argues that corporate organs differ from, and complement, the other type of corporate actor (corporate agents) in the allocation of discretion whether to approve acts that are in the fiduciary duty penumbra. For agents, this oversight function is given to the beneficiary (the principal); for organs, it is given to judges.

The nature of an officer's fiduciary duties depends on whether oversight by the beneficiary, or by judges, would maximize accountability. The answer differs between officers, so in contrast to the arguments of both sides of the debate, officers should not be uniformly classified as agents or organs. Such classification is best left to private ordering. Extant law allows for such private ordering but provides officers with an incentive to maintain an ambiguous status. This Article suggests tweaks to the law that would incentivize officers to self-select their status as organs or agents.

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I. INTRODUCTION

On July 11, 2008, Indymac Bank (Indymac) was seized by the Federal Deposit Insurance Corporation (FDIC) in what was at the time the third largest bank failure in U.S. history.[1] Indymac had accumulated a large pool of risky residential loans known as Alt-A, a type of mortgage that can often be offered to borrowers who do not fully document their incomes or assets.[2] The bank intended to sell these loans on the secondary market, but as the turmoil that later became known as the Great Recession unfolded, the secondary market in mortgages withered and Indymac was forced to transfer the loans to its own investment portfolio.[3] As defaults on loans increased, Indymac's solvency was called into question, triggering a run on the bank that saw spooked investors withdrawing $1.3 billion in eleven days and forcing the FDIC to seize the bank and cover the losses of insured depositors.[4]

The FDIC subsequently sued Indymac's CEO Matthew Perry for breach of his fiduciary duties to Indymac, alleging that Perry negligently

1. Damian Paletta & David Enrich, *Crisis Deepens as Big Bank Fails: IndyMac Seized in Largest Bust in Two Decades*, WALL ST. J., July 12–13, 2008, at A1.
2. *Id.*
3. FDIC v. Perry, No. CV 11–5561–ODW (MRWx), 2012 WL 589569, at *1 (C.D. Cal. Feb. 21, 2012).
4. *Id.* at *1; Paletta & Enrich, *supra* note 1.

permitted the production of the loan pool that caused Indymac losses in excess of $600 million.[5] Perry moved to dismiss the suit, invoking the Business Judgment Rule (BJR)—the principle that, absent evidence of bad faith or self-dealing, a court does not second-guess the business judgment of the corporation's organs.[6]

It is common for a defendant to invoke the BJR in a motion to dismiss claims of breach of fiduciary duties.[7] Indeed, the BJR was developed precisely to shield organs of the corporation from lawsuits that call on the court to second guess the direction in which corporate organs steer the corporation.[8] In almost all of those cases, however, the defendants are the corporation's directors. Does the BJR apply to the business judgment of an officer, such as the CEO?[9]

In *FDIC v. Perry*, a U.S. district court answered that the BJR does not apply to officers, citing lack of precedent supporting defendant's argument and lack of reference to officers in California's statutory expression of the BJR.[10] In contrast, the latest word from the Delaware Supreme Court on the status of officer fiduciary duties, which came in *Gantler v. Stephens*,[11] is "that officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and that the fiduciary duties of officers are the same as those of directors."[12] This conclusive determination came with even less explanation or analysis than was provided by the *Perry* court.[13]

5. *Perry*, 2012 WL 589569, at *1.

6. *Id.* at *2. On the BJR, see Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000) ("The business judgment rule is an acknowledgment of the managerial prerogatives of Delaware directors under Section 141(a). It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption." (citations omitted)).

7. *See* Spiegel v. Buntrock, 571 A.2d 767, 777 (Del. 1990) (stating in the context of derivative litigation that when the requirements of the BJR are met, "a board of directors' motion to dismiss an action filed by a shareholder, whose demand has been rejected, must be granted"); DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS 492 (3d ed. 1989) ("When used in this manner, the rule is said to be applied 'offensively'—it is used not to defend the propriety of the underlying action but rather to secure dismissal of the suit without reaching the merits of the claim."); Elizabeth A. Nowicki, *A Director's Good Faith*, 55 BUFF. L. REV. 457, 475 (2007) (discussing the difficulty of rebutting the BJR in a motion to dismiss).

8. *In re* Goldman Sachs Grp., Inc. S'holder Litig., No. 5215-VCG, 2011 WL 4826104, at *23 (Del. Ch. Oct. 12, 2011) ("Through the business judgment rule, Delaware law encourages corporate fiduciaries to attempt to increase stockholder wealth by engaging in those risks that, in their business judgment, are in the best interest of the corporation without the debilitating fear that they will be held personally liable if the company experiences losses." (internal quotation marks omitted)).

9. Perry was also a director of Indymac, but the court found that plaintiff properly alleged that his actions were in his capacity as the CEO, therefore forcing a decision as to the application of the BJR to officers. *Perry*, 2012 WL 589569, at *4.

10. *Id.* at *3–4.

11. Gantler v. Stephens, 965 A.2d 695 (Del. 2009).

12. *Id.* at 708–09.

13. *See Perry*, 2012 WL 589569 at 3–4.

As the *Perry* court recognized, however, "the distinction as to whether BJR applies to both corporate officers and directors has been the subject of much academic debate."[14] The articles produced in this rich academic debate focus on the suitability (and potential for abuse) of the BJR in light of the realities of corporate governance, such as de facto authority exercised by senior officers.[15]

The focus on the BJR is unsurprising given the rule's importance in litigation and its impact on the balance of power between executives and shareholders. But this Article argues that the focus on the BJR obscures the policy debate, because the BJR is only one component in a more elaborate legal ecosystem that governs those who act on behalf of the corporation. As explained below,[16] while the BJR constrains judicial oversight, it is part of the broader system that governs corporate organs (as distinguished from corporate agents); a system that, as a whole, expands rather than constrains judicial oversight. Thus—contrary to the conclusion we might reach if we focus solely on the BJR—we should treat officers as organs (which, among other things, will allow them to benefit from the BJR) if we believe officers would be made more accountable through greater judicial oversight over officers' actions. Conversely, where judicial oversight is less effective in maintaining accountability than the oversight of the board, we should prefer to treat officers as agents (which, among other things, would deny them the benefit of the BJR). Key to this Article's analysis is the insight that the BJR is not the main device that balances accountability with efficiency, but rather a component in a regulatory ecosystem that (counterintuitively) increases judicial oversight at the expense of beneficiary oversight. This Article will argue that the main problem with current precedents that apply the BJR to officers is that they fail to apply the complete regulatory ecosystem, which would deny those officers who benefit from the BJR the ability to also shield themselves from judicial oversight by receiving the board's consent or ratification to their actions.

The analysis in the Article proceeds as follows: Part II sketches a theory of corporate organs, explaining first (in Section II.A) why we need corporate organs (rather than applying the law of agency to all corporate actors), then (in Section II.B) analyzing the differences between the fiduciary duties of directors (the prototypical corporate organ) and those of corporate agents. Finally, Section II.C recasts the distinction between corporate organs and agents as a choice between reliance on judi-

14. *Id*. at *3.

15. *See, e.g.*, Paul Graf, *A Realistic Approach to Officer Liability*, 66 BUS. LAW. 315 (2011); Lawrence A. Hamermesh & A. Gilchrist Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 BUS. LAW. 865 (2005); Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW. 439 (2005); Lyman Johnson & Robert Ricca, *Reality Check on Officer Liability*, 67 BUS. LAW. 75 (2011); Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers Are Fiduciaries*, 46 WM. & MARY L. REV. 1597 (2005).

16. *See infra* Section II.B.

cial oversight or beneficiary oversight to maintain the actor's accountability.[17]

Part III then applies corporate organ theory to the officer fiduciary duties debate. Section III.A finds, contrary to both the *Gantler* (officer as organ) and the *Perry* (officer as agent) camps, that a uniform treatment of officers is inappropriate because of the variance in their susceptibility to beneficiary oversight. Some officers can dominate their overseer (the person(s) exercising oversight of corporate agents; typically, the board)[18] and therefore beneficiary oversight would not effectively keep the officers accountable. These officers should be constrained by judicial oversight, and to do so they need to be classified as organs. Other officers, however, are efficiently held accountable by the beneficiary, and to facilitate beneficiary oversight we should treat these officers as agents.

Since a uniform approach to officer status is inefficient, Section III.B considers the ability to rely on private ordering, whereby a corporation would select which of its officers will be treated as agents and which as organs. As that Section explains, current law facilitates such private ordering, by allowing a corporation to designate in its Certificate of Incorporation actors other than directors who will receive authority otherwise preserved for directors, and who in that sphere will be subject to (directors') fiduciary duties. Thus, a corporation can designate in its Certificate of Incorporation the officers that should be treated as organs and the sphere of authority in which they act as organs, and such officers would be treated as organs. All other officers will be treated as agents (so they would be subject to beneficiary oversight and would not benefit from the BJR).

To this author's knowledge, corporations do not make use of this invitation for private ordering, and Section III.C speculates why that is the case: as it stands now, the law (at least where *Gantler* is followed) allows officers who remain ambiguous as to their status to benefit from the BJR, while at the same time seek cover from the board against challenges to their actions.[19] The former is a benefit afforded to the corporate or-

17. In this Article, I consider the corporation (not the shareholders) to be the beneficiary of the fiduciary duties of corporate actors. Under some circumstances involving horizontal (majoritarian) agency problems, corporate actors may owe fiduciary duties directly to shareholders. *See, e.g.*, Frank v. Elgamal, No. 6120–VCN, 2012 WL 1096090, at *7–11 (Del. Ch. Mar. 30, 2012) (denying a motion to dismiss a claim that directors failed to ensure that a merger in which target's controller received different compensation than target's minority shareholders was fair to the minority shareholders).

18. Since the beneficiary (the corporation) is an artificial entity, it needs some actor to exercise oversight of the corporate agents. In this Article I call this actor the overseer. The board of directors (board) is typically the overseer for a beneficiary that is a corporation. DEL. CODE ANN. tit. 8, § 141(a) (2013) ("The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors . . . .").

19. *See* Gantler v. Stephens, 965 A.2d 695, 708–09 (Del. 2009) ("In the past, we have implied that officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and that the fiduciary duties of officers are the same as those of directors. We now explicitly so hold."). The Delaware Supreme Court's statement that officers' fiduciary duties are "the same as those of directors" logically suggests that the BJR applies to officers as it applies to directors, and this Article will assume

gan, the latter is a benefit afforded to the corporate agent. By allowing officers to benefit from both, the law creates little incentive for officers to designate themselves as organs and lose some of their protections. Part IV concludes with suggested tweaks to the law that would correct incentives, forcing officers to choose between the two governance systems—the one governing corporate organs and the one governing corporate agents.

II. CORPORATE ORGAN THEORY

A. *What Are Corporate Organs?*

Since a corporation is an artificial entity, it must act through others (corporate actors).[20] Corporate actors are divided into two types: corporate agents and corporate organs.[21] Corporate agents—like all agents—act on behalf of the corporation and subject to its control.[22] Yet being an artificial entity, the corporation itself cannot control anyone; it needs another type of actor—the corporate organ, who acts on the corporation's behalf but is not subject to its control. Corporate organs—in particular the board—assert the corporation's control over the agents.

In early stages of corporate law's development, agency law governed the conduct of all corporate actors—agents as well as organs.[23] Applying agency law was awkward: How could an artificial entity manifest its control of the agents, or even manifest its assent to make someone its agent? Lower-level employees, who are subordinate co-agents,[24]

that was the *Gantler* court's intention. *Id.* at 709. Some scholars, however, disagree with this interpretation and claim that the relevance of the BJR to directors remains ambiguous following *Gantler*. *See* Lyman Johnson & Dennis Garvis, *Are Corporate Officers Advised About Fiduciary Duties?*, 64 BUS. LAW. 1105, 1107–08 (2009) ("Strikingly, the court did not mention the business judgment rule in its analysis of claims against the officers, although it did so with respect to claims against the directors. For the latter, the court applied the usual analytical framework of requiring the plaintiffs' claims to overcome the presumptions of the business judgment rule (which they did). For claims against the officers, however, the court took a different approach, finding that the allegations 'state a claim that they breached their fiduciary duties as officers.' Thus, whether and how the business judgment rule applies to officers in Delaware remains unclear."). Even if *Gantler* does not apply the BJR to officers, precedents in other jurisdictions do. *See* Douglas H. Flaum & Shahzeb Lari, *The Applicability of the Business Judgment Rule to Corporate Officers After* Gantler v. Stephens, 41 SEC. REG. & L. REP. 622, 624 n.17 (2009). The concerns expressed in this Article regarding the application of the BJR to officers apply to those precedents.

20. PAUL L. DAVIES, GOWER'S PRINCIPLES OF MODERN COMPANY LAW 178 (6th ed. 1997).

21. *Id.* at 15.

22. RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006) ("Agency is the fiduciary relationship that arises when [principal and agent manifest assent] that the agent shall act on the principal's behalf and subject to the principal's control . . . .").

23. RON HARRIS, INDUSTRIALIZING ENGLISH LAW: ENTREPRENEURSHIP AND BUSINESS ORGANIZATION, 1702–1844, at 140 (2000) (stating that under the law applied to unincorporated companies in the late eighteenth and early nineteenth centuries, "the relationship between officers and shareholders as well as some other relationships among internal organs were subject to agency law").

24. Subordinate co-agents are agents who are subordinate to other agents of the same principal, such as a Vice President of Acme Corporation, who is subordinate to the President of Acme. *See* RESTATEMENT (THIRD) OF AGENCY § 1.04(9).

could satisfy the test for agency if they are subject to the control of superior co-agents (such as the general manager or CEO). But this legal construction only works if the most superior co-agents (e.g., the directors) are agents of the corporation. Yet there is no one who can, on behalf of the corporation, assent to making them agents or assert over them the corporation's control. It is turtles all the way down.[25]

At first, corporate law sidestepped the problem by relying on formalism: a corporation's acts were those authenticated by its seal; thus, an appointment of an actor as an agent (and any purported manifestation of control over the actor) was deemed a manifestation of the corporation if it bore the company seal.[26] Later, the act of the majority of the shareholders in a shareholder meeting was deemed to be, as a matter of law, the act of the corporation.[27] Thus the election of directors at the shareholder meeting was seen as an act of the corporation, allowing directors to be seen as the corporation's agents (and, in turn, hire subordinate agents to conduct the business of the corporation).[28] Finally, language in corporate statutes that vested managerial authority in the board was seen to be the source of an organ's authority to act on behalf of the corporation.[29] This allowed corporate organs to break away from agency law altogether,[30] and derive both their powers and obligations from a newly developed body of law modeled on agency law but tailored to fit the realities of corporate management (organ law).[31] Organ law differs from agency law most significantly in its treatment of fiduciary duties. Because this Article aims at contributing to the officer fiduciary duties debate, it will be concerned with the structure of fiduciary duties applying to each type of actor and will not address other issues that may distinguish organs from agents, such as the allocation or responsibilities or authority between them.

25. For one of the many versions of the "turtles all the way down" story, see CLIFFORD GEERTZ, THE INTERPRETATION OF CULTURES 28–29 (2000 ed.) ("There is an Indian story—at least I heard it as an Indian story—about an Englishman who, having been told that the world rested on a platform which rested on the back of an elephant which rested in turn on the back of a turtle, asked . . . what did the turtle rest on? Another turtle. And that turtle? 'Ah, Sahib, after that it is turtles all the way down.'").

26. DAVIES, *supra* note 20, at 178.

27. *Id.* at 179.

28. *Id.*

29. *Id.*

30. *See* RESTATEMENT (SECOND) OF AGENCY § 14C (1958) ("Neither the board of directors nor an individual director of a business is, as such, an agent of the corporation or of its members."); Arnold v. Soc'y for Sav. Bancorp, Inc., 678 A.2d 533, 539–40 (Del. 1996) ("Directors, in the ordinary course of their service as directors, do not act as agents of the corporation . . . . An agent acts under the control of the principal. The board of directors of a corporation is charged with the ultimate responsibility to manage or direct the management of the business and affairs of the corporation. A board of directors, in fulfilling its fiduciary duty, controls the corporation, not *vice versa*." (citations omitted)).

31. For example, unlike agents and trustees, corporate organs are often not legal entities. This is the case of both the board and the shareholder meeting, both of which are collective bodies of individuals, but the collective lacks a legal personality. Both of these actors can act on behalf of the corporation, but lacking legal personality, they cannot act on behalf of themselves.

B. The Legal Differences Between Organ and Agent Fiduciary Duties

When the fiduciary duties of organs (specifically, of directors) is contrasted with that of agents, the BJR typically receives much attention. An organ receives the benefit of the BJR when its acts are challenged; an agent does not.[32] The BJR constrains judicial oversight by requiring (unless it is rebutted) that the court defer to the business judgment of the corporate actor.[33] Thus, exclusive focus on the BJR would (wrongly) suggest that organ law, relative to agency law, provides for less judicial oversight in assessing whether fiduciary duties were breached.

Such a distinction would make no sense as a matter of legal policy. By definition, organs are not subject to the beneficiary's control when acting on behalf of the beneficiary (if they were subject to the beneficiary's control, they would be agents).[34] If the policy of organ fiduciary duties was to reduce judicial oversight in assessing organs' behavior (relative to judicial oversight of agents), then there would be little in the legal design to keep organs accountable. Conversely, agents are by definition subject to the beneficiary's control.[35] If the policy of agent fiduciary duties was to increase judicial oversight in assessing an agent's behavior, it would present the agent with two potentially conflicting masters—the beneficiary and the judge—unnecessarily increasing the agent's legal uncertainty.

The legal policy behind agent and organ fiduciary duties is not flawed, however, because the BJR is not the only—or even the main—distinction between the fiduciary duties of agents and organs. Rather the distinctions can be grouped into three categories.

1. Organs Are Limited in Their Ability to Seek Cover from the Beneficiary

A beneficiary's ability to absolve an organ from liability for breaching fiduciary duties is more limited than its ability to absolve an agent. In the case of agents, a principal's informed consent to an agent's action prevents the action from breaching the duty of care (since the duty is "[s]ubject to any agreement with the principal"),[36] and prevents the action from breaching the duty of loyalty as long as the consent "concerns either a specific act or transaction, or acts or transactions of a specified type."[37]

32. *See, e.g.*, William K. Sjostrom, Jr., *Tapping the Reservoir: Mutual Fund Litigation Under Section 36(A) of the Investment Company Act of 1940*, 54 U. KAN. L. REV. 251, 286 (2005) ("[T]here is no equivalent to the business judgment rule . . . under agency law . . . .").

33. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000); 18B AM. JUR. 2D *Corporations* §§ 1470–71 (2004).

34. RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006); *see also Arnold*, 657 A.2d at 539–40.

35. RESTATEMENT (THIRD) OF AGENCY § 1.01.

36. *Id.* § 8.08.

37. *Id.* § 8.06(1)(b).

Conversely, in the case of organs (directors), the approval of an action by the beneficiary does not immunize a transaction from judicial scrutiny,[38] at least against violations of the duty of loyalty.[39] Rather, such approval (typically, in the form of a ratification by shareholders) shifts the burden of proof to the plaintiff to demonstrate the unfairness of the challenged act, and in some cases may shift the standard of review from entire fairness to the BJR.[40] These provide the organ with advantages in litigation, but not complete immunity—a court that finds an act amounted to corporate waste, for example, can find a breach of fiduciary duties in an organ's act even if the beneficiary approved it.[41] Furthermore, not all actions undertaken by an organ can be ratified by the beneficiary. Courts have long held, for example, that acts amounting to corporate waste cannot be ratified.[42] More recently, *Gantler v. Stephens* clarified that shareholders cannot ratify an issue when their vote is necessary to approve that issue, such as approving a merger of the corporation.[43]

2. *There Are More Grounds for Finding that an Organ Breached Fiduciary Duties*

Agents breach their fiduciary duties when they act negligently,[44] or when they self-deal (either by acting as an agent when they have a conflict between their self-interest and the interest of their principal, or by personally benefiting from the fiduciary relationship or from a tangible

38. Gantler v. Stephens, 965 A.2d 695, 713 (Del. 2009) ("With one exception, the 'cleansing' effect of such a ratifying shareholder vote is to subject the challenged director action to business judgment review, as opposed to 'extinguishing' the claim altogether (i.e., obviating all judicial review of the challenged action)."). The exception is not a species of breach of fiduciary duties, but a claim that directors lacked authority to take the ratified action. *Id.* at 713 n.54.

39. Organs can receive ex ante consent to good faith, unintentional violations of the duty of care through a provision in the Certificate of Incorporation that limits or eliminates their personal liability for such violations, as authorized in section 102(b)(7) of the Delaware General Corporation Law. DEL. CODE ANN. tit. 8, § 102(b)(7) (2013). Section 102(b)(7) does not allow such consent to violations of the duty of loyalty or to bad faith or intentional violations of the duty of care. *Id*.

40. *In re* Wheelabrator Techs., Inc. S'holders Litig., 663 A.2d 1194, 1202–03 (Del. Ch. 1995) ("[N]o Supreme Court case has held that shareholder ratification operates automatically to extinguish a duty of loyalty claim. To the contrary, the ratification cases involving duty of loyalty claims have uniformly held that the effect of shareholder ratification is to alter the standard of review, *or* to shift the burden of proof, *or* both.").

41. Harbor Fin. Partners v. Huizenga, 751 A.2d 879, 896 (Del. Ch. 1999) ("[V]oid acts are said to be nonratifiable because the corporation cannot, in any case, lawfully accomplish them. Such void acts are often described in conclusory terms such as . . . 'gifts or waste of corporate assets.'"). As a partial exception to this rule, unanimous (but not merely majority) shareholder ratification, while not ratifying per se, precludes shareholders from challenging the purportedly ratified action. *Gantler*, 965 A.2d at 713 n.54. Of course, a unanimous shareholder vote is practically impossible in public corporations, making this partial exception irrelevant to such corporations.

42. *Huizenga*, 751 A.2d at 896.

43. *Gantler*, 965 A.2d at 713 ("[T]he scope of the shareholder ratification doctrine must be limited . . . to circumstances where a fully informed shareholder vote approves director action that does *not* legally require shareholder approval in order to become legally effective.").

44. RESTATEMENT (THIRD) OF AGENCY § 8.08 (2006).

or intangible asset belonging to the principal).[45] Organs breach their fiduciary duties when they act negligently and when they self-deal, but also when they act in bad faith, even if there is no allegation or evidence of negligence or self-dealing, since bad faith is an element of the organ's duty of loyalty.[46] Thus, grounds for breaching fiduciary duties are broader for organs than for agents.[47]

45. *Id.* §§ 8.01–.05. Agents also have a duty of good conduct, which amounts "to act[ing] reasonably and [refraining] from conduct that is likely to damage the principal's enterprise." *Id.* § 8.10. This is a much narrower duty than the organ's duty of good faith; indeed, the duty of good conduct is not part of an organ's fiduciary duties, but an application of the much less intrusive contractual duty of good faith and fair dealing. Auriga Capital Corp. v. Gatz Props., LLC, 40 A.3d 839, 854 n.60 (Del. Ch. 2012) (distinguishing the contractual duty of good faith and fair dealing from the good faith element of the fiduciary duty of loyalty); Gerber v. Enter. Prods. Holdings, LLC, No. 5989–VCN, 2012 WL 34442, at *13 n.58 (Del. Ch. Jan 6, 2012). ("[A]lthough the covenant of good faith and fair dealing may sound like some grandiose principle, it is a gap-filler. . . . [T]he implied covenant does not . . . prohibit defendants from acting beyond the outer bounds of reasonableness . . . . Rather, as the Supreme Court has explained, if a contract has no gaps, then the implied covenant is not applicable to that contract." (citations and internal quotation marks omitted)).

46. *See* Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) ("[T]he fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith."); *see also* Sample v. Morgan, 914 A.2d 647, 670 (Del. Ch. 2007) ("When pled facts support an inference of [corporate waste, a form of bad faith act], judicial nostrils smell something fishy and full discovery into the background of the transaction is permitted. In the end, most transactions that actually involve waste are almost found to have been inspired by some form of conflicting self-interest. The doctrine of waste, however, allows a plaintiff to pass go at the complaint stage even when the motivations for a transaction are unclear by pointing to economic terms so one-sided as to create an inference that no person acting in a good faith pursuit of the corporation's interests could have approved the terms.").

47. Agents' actions are more vulnerable than those of the board of directors to challenges based on lack of authority, because an agent's authority is limited to the actual and apparent authority created by a principal's manifestations, while the authority of the board of directors is plenary and therefore only when the authority for a particular act has been specifically given to another actor (e.g., the authority to remove directors from the board) will the board exceed its authority. RESTATEMENT (THIRD) OF AGENCY § 3.01 ("Actual authority . . . is created by a principal's manifestation . . . ."); *id.* § 3.03 ("Apparent authority . . . is created by a person's manifestation . . . ."); DEL. CODE ANN. tit. 8, § 141(a) (2013) ("The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors . . . ."); *id.* § 141(k) (allocating the authority to remove directors to shareholders). This does not, however, contradict my claim that grounds for breaching fiduciary duties are broader for organs than for agents. First, authority is not an element of fiduciary duties, but rather an alternative flaw in a challenged action. Fiduciary duties require that *a proper purpose* guides an actor's authorized behavior. They impose a second layer of scrutiny that assumes an act has already passed the first layer of scrutiny requiring an actor to act within prescribed authority. Second, only the board of directors has plenary authority. Committees of the board, which also act as organs of the corporation, are only authorized to act within the scope that has been delegated to them from the board, and the scope of delegation is limited by law. *See id.* § 141(c)(2) (specifying matters that cannot be delegated to a board committee). In addition, other actors that may be perceived as organs of the corporation (such as the shareholder meeting) do not have plenary authority. Therefore, the fact that agents have more limited authority than the board does not contradict my assertion that the grounds for breaching fiduciary duties are broader for organs than for agents.

3. *A Plaintiff Faces Greater Litigation Burdens Challenging an Organ's Act*

A plaintiff who challenges the act of an organ faces three significant obstacles she would not face had the act been conducted by an agent: the BJR, higher standards for breach by negligence, and higher standards for breach by self-dealing.

First, as mentioned above,[48] the BJR is a judicial presumption that an organ's business decision was proper. Subject to specific exceptions, the BJR requires that the court defer to the organ's business judgment. Thus, the plaintiff must adequately allege (at the pleading stage) and prove (in trial) the occurrence of one of the exceptions that allow rebuttal of the BJR.[49] A plaintiff does not face a similar presumption when challenging an agent's act.[50]

Second, a plaintiff who claims that an organ breached fiduciary duties by acting negligently must allege and prove gross negligence.[51] In contrast, the plaintiff would only need to demonstrate ordinary negligence to find that an agent's act breached fiduciary duties.[52]

Third, a plaintiff who claims that an organ breached fiduciary duties by self-dealing does not prevail if the court finds that the act was fair to

48. *See supra* Part I.

49. *See, e.g.*, McMullin v. Beran, 765 A.2d 910, 917 (Del. 2000) (stating that to overcome the presumption, a plaintiff "must effectively provide evidence that the defendant . . . breached any *one* of its triad of fiduciary duties, loyalty, good faith or due care. . . . [I]f the shareholder plaintiff fails to meet that evidentiary burden, the business judgment rule attaches and operates to protect the individual director-defendants from personal liability for making the board decision at issue") (internal quotation marks omitted); Fields v. Sax, 462 N.E.2d 983, 989 (Ill. 1984) ("Absent evidence of bad faith, fraud, illegality, or gross overreaching, courts are not at liberty to interfere with the exercise of business judgment by corporate directors.").

50. *See, e.g.*, Sjostrom, *supra* note 32, at 286 ("[T]here is no equivalent to the business-judgment rule . . . under agency law . . . .").

51. Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985) ("[T]he concept of gross negligence is . . . the proper standard for determining whether a business judgment reached by a board of directors was an informed one."). The cases above apply to Delaware law, but the negligence standard in jurisdictions following the Model Business Corporation Act is similar in substance. *See* Adam J. Richins, *Risky Business: Directors Making Business Judgments in Washington State*, 80 WASH. L. REV. 977, 986 (2005) ("The term 'gross negligence' is not part of the MBCA. Nonetheless, the American Bar Association (ABA) has developed a similar standard, which respects a director's decision-making process unless the 'preparation to make an informed judgment is so unreasonable as to fall outside the permissible bounds of sound discretion.' Thus, a director may fail to comply with the ordinarily prudent person standard of conduct when becoming informed, but still avoid liability under the business judgment rule." (quoting another source)); *see also* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000) ("[U]nder the business judgment rule director liability is predicated upon concepts of gross negligence.").

52. Johnson & Millon, *supra* note 15, at 1637 ("[A]gency law imposes an ordinary negligence standard of care that is tougher than the 'gross negligence' standard applicable to corporate directors.").

the beneficiary.[53] In contrast, acting while conflicted would suffice to prove breach for an agent, even if the act was fair to the beneficiary.[54]

This cluster of distinctions may seem random, but it melds together into two coherent and alternative policies to hold corporate actors accountable. These policies are explained in the next Section.

C. The Policy Distinction Between Organ and Agent Fiduciary Duties

Agency law and organ law share the purpose of efficiently maintaining the accountability of their respective corporate actors. They differ in the means by which they do so; specifically, in allocating the discretion to approve or condemn acts that are in the fiduciary duty penumbra.

Fiduciary duties apply ex post and cannot be precisely defined ex ante (or they would be easy for the actor to bypass).[55] Thus, fiduciary duties enhance actors' accountability at the cost of creating legal uncertainty. Yet fiduciary duties are not oblivious to the trade-off, but rather attempt to strike a balance between accountability and legal certainty.[56] Behavior that is in the core of fiduciary duties violations (say, an actor embezzling money from the corporation) would be similarly treated by all versions of fiduciary duties: condemning it would not create legal uncertainty, since the actor can be expected to know the action was wrong. The same holds for condoning actions that are clearly outside the scope of fiduciary duties (such as an actor who thoughtfully steered the corporation to business opportunities she in good faith believed promising, but that ultimately failed).

In contrast, actions in the fiduciary duty penumbra—actions that a reasonable person would find somewhat questionable but also somewhat justified—present a tension between accountability and legal certainty. Most commonly, these are situations in which it is not obvious that the challenged act was, at the time it was taken, harmful to the beneficiary, but the circumstances suggest a plausible inappropriate motive—such as a transaction in which the actor had a conflict of interest,[57] or a situation

53. Bayer v. Beran, 49 N.Y.S.2d 2 (N.Y. Sup. Ct. 1944) (finding that a CEO who hired his wife to perform a radio commercial for his corporation did not breach fiduciary duties despite the conflict of interest, because the transaction was fair to the corporation).

54. RESTATEMENT (THIRD) OF AGENCY § 8.03 cmt. b (2006) ("Even if the agent's divided loyalty does not result in demonstrable harm to the principal, the agent has breached the agent's duty of undivided loyalty.").

55. *See* Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 427 (1993) ("[A] 'fiduciary' relation is a contractual one characterized by unusually high costs of specification and monitoring. The duty of loyalty replaces detailed contractual terms, and courts flesh out the duty of loyalty by prescribing the actions the parties themselves would have preferred if bargaining were cheap and all promises fully enforced.").

56. *See, e.g.*, Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 107–09 (2004) (discussing the balance that the BJR strikes between authority and accountability).

57. *See, e.g.*, *Bayer*, 49 N.Y.S.2d at 9.

in which the actor facilitates a deal in which the corporation's controller receives different terms than the minority shareholders.[58]

Agency law and organ law differ in the allocation of discretion to determine whether actions in the fiduciary duty penumbra breached fiduciary duties. Agency law creates an incentive for an actor who is considering an act in the fiduciary duty penumbra to seek the beneficiary's (i.e., the principal's) approval, preferably prior to conducting the act. This is done by empowering the beneficiary to approve actions that would otherwise be seen to breach fiduciary duties while at the same time, curtailing judicial oversight by preventing judges from overruling beneficiary-approved actions or exonerating unapproved actions that seem justified to the judge.[59] In contrast, organ law affords judges broad discretion in deciding whether to approve actions in the fiduciary duty penumbra, while curtailing the beneficiary's ability to approve of such conduct.

Consider first the rules governing fiduciary duties under agency law. Beneficiary oversight is empowered by the broad ability of the beneficiary (i.e., the principal) to approve acts that would otherwise breach fiduciary duties.[60] At the same time, agency law constrains judicial oversight. A "punitive judge" (in the sense that the judge wishes to condemn an act that the beneficiary approved) is constrained because a beneficiary's approval prevents the act from breaching fiduciary duties. For example, suppose that Patrick hires Anna to buy him a car, and Anna buys on Patrick's behalf a car that was owned by Anna, at a price that is ten times the car's market value. Anna, however, provides all material information to Patrick (including the fact that she is the seller of the car, and that the car's value is a tenth of the price Patrick is paying). For reasons unknown to us, Patrick decides to ratify the purchase. As long as the ratification satisfies the requirements of *Restatement (Third)* section 8.06, a paternalistic judge who would like to invalidate the transaction would be unable to do so.[61] In contrast, if Anna was the sole director of PatCo, approving the sale of her car to PatCo for ten times its value, a judge could find that Anna breached her fiduciary duties and committed corporate waste, even if the majority of PatCo's fully informed shareholders ratified the transaction.

58. *See, e.g.*, Frank v. Elgamal, No. 6120–VCN, 2012 WL 1096090 (Del. Ch. Mar. 30, 2012); *In re* John Q. Hammons Hotels Inc. S'holder Litig., No. 758–CC, 2009 WL 3165613 (Del. Ch. Oct. 2, 2009) (noting that the controller of corporation received different terms than minority shareholders in a third-party acquisition approved by the target's board).

59. RESTATEMENT (THIRD) OF AGENCY § 8.06(1) ("Conduct by an agent that would otherwise constitute a breach of [fiduciary] duty . . . does not constitute a breach of [fiduciary] duty if the principal consents to the conduct . . . ."). Since the consented conduct is deemed not to breach the agent's fiduciary duties, a judge cannot substitute her judgment for the principal's and condemn the action.

60. *Id.*

61. *Id.* (stating that an agent's conduct "does not constitute a breach of duty if the principal consents to the conduct").

A "merciful judge" (in the sense that the judge wishes to condone an act that the beneficiary did not approve of) is constrained by the lower standards for breach (ordinary negligence and automatic breach for self-dealing). Consider again agent Anna's acquisition for principal Patrick of Anna's car, but assume that the price is one-tenth of the car's value, and that Patrick did not take any action following the transaction (i.e., did not ratify). Patrick later decides to sue Anna for breach of fiduciary duties, perhaps for reasons that are unrelated to the transaction. A judge may find that the transaction was more than fair to Patrick, yet would have to rule in Patrick's favor because Anna clearly had a conflict of interest in the transaction. In contrast, if Anna was the sole director of PatCo, and PatCo's shareholders later sued Anna, the BJR would be rebutted due to Anna's conflict of interest, but a judge could nonetheless find that Anna did not breach her fiduciary duties because the transaction was fair to the corporation.[62]

Now consider the rules that govern fiduciary duties under organ law. Beneficiary oversight is constrained by the rule that beneficiary ratification does not extinguish duty of loyalty claims (but merely confers some advantages to the actor in litigation—shifting of the burden of proof and sometimes changing the standard of review).[63] At the same time, judicial oversight is empowered by several of the rules. Bad faith grounds for breach of fiduciary duties allow a judge to condemn acts even in the absence of evidence of negligence or self-dealing.[64] The higher standards for breach increase judicial oversight because the standards of gross negligence and fairness, which challenged acts of organs must satisfy, facilitate the application of the judge's discretion. A merciful judge can find that a transaction is fair (as in one of the agent Anna variations, above) or that an act, even if negligent, was not grossly negligent—allowing the judge to condone an act that the beneficiary condemns. Meanwhile, a punitive judge can also insert her discretion into the fairness and gross negligence tests and find an act breached fiduciary duties.

How does the BJR fit into this legal ecosystem? The BJR is a backstop that is necessary to allow the significant increase in judicial oversight facilitated by the other rules. Unlike the beneficiary, who bears the consequences of its oversight, judges are unaffected by the consequences of their discretion. Without the BJR, it would be difficult to hold judges accountable. Because organ law faces an accountability concern that agency law does not, it requires the BJR, which forces judges to justify their intervention.

62. *Cf. Bayer*, 49 N.Y.S.2d at 14–15.

63. *In re* Wheelabrator Techs. Inc. S'holder Litig., 663 A.2d 1194, 1202–03 (Del. Ch. 1995).

64. *In re* Answers Corp. S'holder Litig., No. 6170–VCN, 2012 WL 3045678, at *3 (Del. Ch. 2012) ("Directors can act in bad faith in breach [of] their duty of loyalty even if there is no whiff of self-dealing from their actions.").

III. THE OFFICER FIDUCIARY DUTIES DEBATE IN LIGHT OF CORPORATE ORGAN THEORY

A. Officers Are Not Uniformly Organs or Agents

At the core of the officer fiduciary duties debate lies the question of whether officers are organs (and thus, among other things, should benefit from the BJR and the higher breach thresholds) or agents. This classification depends on whether actions that are in the fiduciary duty penumbra should be overseen by the beneficiary (or more precisely, the overseer) or by judges.

Beneficiary oversight is superior to judicial oversight when effective oversight requires firm-specific knowledge or expertise that the beneficiary possesses.[65] Beneficiary oversight is also superior when a challenged action would benefit more from ex ante review (which the beneficiary can provide) than from ex post review (which is what judicial oversight provides).[66] And as mentioned above,[67] that beneficiary has a stronger incentive to accurately assess the actor's actions, since its fortunes (but not a judge's) rise and fall as a result of these actions.

Judicial oversight is superior to beneficiary's oversight when the actor dominates the beneficiary. Sometimes domination may be considered collusive—the beneficiary willingly defers to the actor. One reason it may do so is that the actor has some "star power" (e.g., the actor's image and association with the corporation is important to the corporation's image, such as Warren Buffett at Berkshire Hathaway, Martha Stewart at Martha Steward Living Omnimedia, or Steve Jobs at Apple). Another reason the beneficiary (specifically, directors overseeing the actor on behalf of the corporation) may willingly defer to the actor is because the persons acting for the beneficiary (e.g., directors) fear that if they challenge the actor they may lose their position on the board or perks received because of board membership.[68] Either of these situations is unlikely to be frequent, because they apply only when the actor either has star power of significant influence on board nominations or board compensation.

65. When evaluating an officer's actions requires general (but not firm-specific) business expertise, the advantage of beneficiaries is less pronounced. Most directors and many activist shareholders are business savvy, but so are some judges who were previously practitioners of business law and/or who have significant experience adjudicating business disputes.

66. Judges can, of course, issue a preliminary injunction and evaluate an action ex ante, but even in the most efficient courts judicial review will likely be slower than board review; and even the most alert plaintiff shareholders may not be aware of many officer decisions in time to petition a court to enjoin them.

67. *See supra* Section II.C (justifying the BJR as a mechanism to maintain judicial accountability given that judges are unaffected by the outcome of their discretion while beneficiaries are affected).

68. *See* Johnson & Millon, *supra* note 15, at 1614 ("There long has been a widespread belief . . . that . . . officers wield greater influence in corporate affairs than do directors."); *id.* at 1651 ("In many corporations today, the CEO effectively chooses 'his' or 'her' board through influence—even if informal—over the choice of director nominees.").

But domination can be noncollusive as well. For example, officers can dominate the board by controlling the board's agenda, the amount of time the board has to react to new information, or the amount and types of information they supply to the board.[69] In these ways officers can constrain the board's ability to oversee them. While collusive domination depends mostly on the type of actor, noncollusive domination tends to depend on the type of beneficiary (or more specifically, the persons overseeing the actor on behalf of the beneficiary). Noncollusive domination is more likely when the overseer cannot or does not work full-time for the corporation or when it lacks key knowledge or expertise that the officers possess—a situation that is not uncommon and is particularly prevalent among independent directors (thus limiting the oversight ability of those directors who have the appropriate incentives to oversee officers).[70]

Applying these criteria, it seems to be a mistake to treat officers uniformly as either agents or organs. Usually, all but the most senior officers lack the star power, the control over the nomination and compensation of the overseer, or the control over the agenda that would be needed to dominate the overseer. Even most senior officers usually have only limited leverage over their boards. Treating these officers as agents would be efficient, because beneficiary oversight would be more effective than judicial oversight.

But the minority of officers who do dominate (collusively or noncollusively) the beneficiary are likely to cause disproportionate harm to the corporation because they tend to be very senior and very confident (the harm caused to MF Global from its CEO Jon Corzine's ability to bypass internal controls on trading comes to mind as an example of the magnitude of damage that can be inflicted by dominant star officers).[71] Judicial

69. *See* Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 864 (1993) ("[T]he CEO almost always determines the agenda and the information given to the board. This limitation on information severely hinders the ability of even highly talented board members to contribute effectively to the monitoring and evaluation of the CEO and the company's strategy."); Nicola Faith Sharpe, *Questioning Authority: The Critical Link Between Board Power and Process*, 38 J. CORP. L. 1, 25 (2012) ("Managers set the agendas for board meetings and control when and what information the board receives.").

70. *See* Nicola Faith Sharpe, *The Cosmetic Independence of Corporate Boards*, 34 SEATTLE U. L. REV. 1435, 1453–56 (2011) (discussing time, information and knowledge constraints on independent directors' oversight capacity).

71. Jon Corzine, a former U.S. Senator, Governor of New Jersey, and CEO of Goldman Sachs, was "greeted like a rock star" when he was hired as the CEO of the mid-sized derivatives broker MF Global. Aaron Lucchetti & Mike Spector, *The Unraveling of MF Global: With $1.2 Billion Still Missing, Corzine's Aggressive Strategy Comes into Focus*, WALL ST. J., Jan. 1, 2012, at B1. According to news reports, he made aggressive bets on European debt, which ultimately failed and caused the bankruptcy of the company. *Id.* Corzine clashed with his Chief Risk Officer over the trades, then replaced him with a new Chief Risk Officer who was stripped of authority "to weigh in on the broader implications the trades might have on the firm, including whether they might undermine investor confidence." Ben Protess & Azam Ahmed, *MF Global's Risk Officer Said to Lack Authority*, N.Y. TIMES, Dec. 15, 2011, at B1. Corzine informed the board about his trades and did not face resistance from them. Aaron Lucchetti & Justin Baer, *Corzine Races to Save Firm: MF Global Imperiled Because of European Bond Bet; Investors Bail After Loss*, WALL ST. J., Oct. 31, 2011, at A1 ("Mr. Corzine regularly reviewed the positions with the company's directors, and he was allowed by the board several times to

oversight of these officers is superior because beneficiary supervision is ineffective. Treating such officers as organs would limit their ability to seek cover from the dominated beneficiary. Conversely, if these officers are considered agents, they can limit judicial oversight by receiving approval for their actions from the dominated beneficiary or by having the beneficiary block derivative lawsuits against the officers.

The above analysis suggests that both camps in the officer fiduciary duties debate are partially wrong. Classifying all officers as organs would create an inefficient accountability system for most officers. On the other hand, classifying all officers as agents would create an inefficient accountability system for a small number of officers whose position and power may cause them, if they are not held accountable, to inflict disproportionately great harm on the corporation.

As explained above, the factors that determine an officer's appropriate classification concern the particular actor's influence and stature and the particular beneficiary's (or more precisely, the particular overseer's) expertise and commitment. Therefore, such factors are firm-specific and sometimes person-specific. A bright line universal classification (e.g., CEOs are always organs, all other officers are always agents) would likely be too rigid and might be difficult to apply given the sometimes diverse ways power is allocated in the business world (e.g., co-CEOs, powerful and autonomous subordinates, officers who have significant informal authority that is not evident from their formal title, etc.).

Another option is to rely on ex post classification by courts, on a case-by-case basis. This would allow consideration of specific circumstances in each case, but would greatly increase uncertainty for the officers, who would not know until they are sued which legal framework they need to comply with.

I believe the most viable option is facilitating private ordering of officer status: each corporation decides and states publicly (before the officers act) which officers will be evaluated as agents and which as organs. This allows the most knowledgeable actor (the corporation itself) to consider the specific circumstances of each officer and of the board's supervisory abilities. Because the decision is made ex ante, it provides certainty for both the officers and for potential plaintiffs.

B. Current Law Allows Private Ordering of Officer Status

Fortuitously, such private ordering is already available under Delaware law: section 141(a) of the Delaware General Corporation Law allows the Certificate of Incorporation to make an exception to the rule that the business and affairs of the corporation are managed by or under

increase MF Global's exposure to Europe . . . ."); *see also* Steven M. Davidoff, *A Board Complicit in MF Global's Bets, and Its Demise*, N.Y. TIMES, Nov. 9, 2011, at B8 (discussing MF Global's board's unwillingness to challenge Corzine's trades).

the direction of the board. If another actor is specified, "the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised . . . by such person or persons as shall be provided in the [articles]."[72]

Thus, a corporation could designate in its charter a particular officer as having autonomous powers to manage certain aspects of the business and affairs of the corporation, while leaving the board with residual authority (e.g., the authority to hire and fire that officer). Such officer would have the same fiduciary duties as a director—i.e., would be an organ. While the board would have some indirect control over the officer through the authority to terminate the officer, the board would not be able to provide the officer with cover from judicial scrutiny by approving an action of the officer. Losing the broad ability to go to the beneficiary for cover is the price an organ pays for benefitting from the BJR (and for enjoying greater autonomy).

Corporations have the ability to select their officers' status, but do they have an incentive to select the "right" status? The right status is the one that keeps officers most accountable, yet presumably officers would like as long a leash as they can have—that is, pick the status that makes them the least accountable.

This is less of a problem than it may seem at first. When beneficiary oversight is effective (i.e., when officers should be agents), officers' would likely not be able to impose their preferences, and the beneficiary would likely maintain the default status of officers as agents. When beneficiary oversight is not as effective as judicial oversight because of noncollusive domination (the board lacks the expertise, time, or control over information or the agenda to adequately supervise the officer), the right status (in this case, organ status) is still likely to be implemented, because the beneficiary (the board) would recognize that it is dominated and not want to face liability for failed oversight without being able to improve the effectiveness of its oversight. For example, if the board realizes it has no effective way of monitoring a CEO, it would likely prefer to unburden itself of an oversight responsibility it cannot adequately execute. By designating the CEO as an organ, they would transfer oversight responsibilities to the courts. Since shareholders (whose approval is required for a Certificate of Incorporation amendment to designate an officer as an organ) are less effective than the board in monitoring the CEO, they would likely want the board to remain an organ alongside the CEO, with the responsibility to monitor the CEO and replace her or take legal action against her if necessary.[73] In practice, this is rather similar to the tasks

72. DEL. CODE ANN. tit. 8, § 141(a) (2013).

73. Noncollusive domination tends to be ineffective in the long term, since it is hard to manipulate and hide information for a long time. Thus, even noncollusively dominated boards can be effective overseers of long-term performance. Since for these purposes beneficiary oversight may be superior to judicial oversight, the board might decide to maintain the authority (and responsibility) for long-term evaluation of the CEO's performance, and for the decision to retain or fire the CEO.

most boards undertake now. The main difference with this approach is that if a CEO-organ is sued, the board's approval of the CEO's actions will not shield the CEO from judicial scrutiny (but, on the other hand, the CEO will benefit from the BJR). In contrast, currently a CEO can rely on agency law to absolve him from liability when the board (acting for the principal) approves his actions, and plaintiff-shareholders' only remedy is suing the board for granting such approval (which may be a weaker case than one premised on the CEO's actions, particularly when the CEO seems to be self-interested while directors are not, but are non-collusively dominated).

Even in some cases of collusive domination the overseer might still insist on effective status selection. Suppose that the board of MF Global is about to hire Jon Corzine. They realize his star power would constrain their ability to oversee him. They may insist that he be designated as an organ, absolving them from liability for failed oversight in areas that Corzine is authorized to act and preventing Corzine from seeking cover by receiving the board's approval. Corzine might not object—in return he would receive greater autonomy, the benefit of the BJR, and higher thresholds for breaching his fiduciary duties. But with no board to provide cover, he will be as fully exposed to judicial assessment of his actions as directors currently are.

Therefore, we should expect corporations to select a less effective status for their officers only in the relatively rare cases of collusive domination (e.g., when directors rubber stamp a CEO's acts in return for the CEO maintaining them as directors and providing lavish perks). Yet, for reasons explained in the next Section,[74] even if a board refuses to admit it is dominated, the current treatment of officers under *Gantler* provides less accountability than allowing dominant officers to maintain agent status.

C. So Why Is Private Ordering Absent?

To this author's knowledge, corporations do not make use of their ability to decide the status of their officers. In the previous Section, I explained why one would expect corporations to have the incentive to select the correct status, even in many cases in which they are ineffective in overseeing the officers. And earlier, I argued that a uniform status for all officers is not feasible.

The lack of private ordering suggests a tension between these two arguments: if corporations' choice (to not assign their officers organ status in the Certificates of Incorporation) is evidence that all corporations believe that all of their officers are agents, it seems to conflict with the claim that officers should not have a uniform status.

74. *See infra* Section III.C (discussing how, under *Gantler*, officers receive the benefits or both agent and organ status).

I believe, however, that there is another explanation for the failure to designate officers as organs: officers' (ambiguous) status in the past as well as officers' status under *Gantler* provides them with the benefits of both the organ and agent status (and therefore makes them less accountable than either agents or organs).[75] Selecting one status or another would result in the officer losing some benefits without gaining anything.

Under *Gantler*, officers are treated like directors, therefore benefiting from the BJR and higher breach thresholds.[76] These are features of organ law that are designed to compensate for the lack of a beneficiary's check on judicial oversight. Yet *Gantler* does not take away the officer's ability to seek cover from the board, which is a feature of agency law that is designed to strengthen beneficiary oversight by curtailing judicial oversight.[77]

The cover a board can provide an officer can be substantive or procedural. Substantive cover is provided by approval of the officer's acts. Under agency law, an approval that conforms to section 8.06 of the Restatement would eliminate the officer's liability for breaching fiduciary duties.[78] Such action might expose the board to liability, though this liability would be narrower in scope since it would evaluate not the officer's act itself but whether the approval of the officer's act, upon reliance on the officer's representations and analysis,[79] was informed and done in good faith by an independent board.

Procedural cover is provided by refusing to cause the corporation to sue the officer. When an officer breaches their fiduciary duties, the cause of action against the officer will belong to the corporation.[80] If the board declines to sue the officer, a shareholder's derivative suit against the officer would only survive summary judgment if a plaintiff can prove demand futility.[81] When a plaintiff's claims arise out of transaction not involving a board decision (e.g., when the claim arises out of an officer's actions), demand futility is assessed under the *Rales*[82] standard, which requires a plaintiff to show reasonable doubt that a majority of directors is independent for purpose of deciding whether to sue the officer. This prevents a shareholder-plaintiff from proceeding in a derivative suit against the officer when the majority of directors is independent, even

75. Gantler v. Stephens, 965 A.2d 695, 705 (Del. 2009).

76. *Id.* at 708–09. On the interpretation of *Gantler* as extending the BJR to officers, see *supra* note 18.

77. *See id.* at 710–11.

78. *See supra* Section II.B.1.

79. The board may rely on officers' representations and analysis under section 141(e) of the Delaware General Corporation Law, codified as DEL. CODE ANN. tit. 8 § 141(e) (2013), "as to matters the [director] reasonably believes are within [the officer's] professional or expert competence."

80. As mentioned *supra* note 17, this Article does not address claims involving horizontal (majoritarian) agency problems, in which fiduciary duties may be owed to minority shareholders.

81. Aronson v. Lewis, 473 A.2d 805, 809 (Del. 1984), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

82. Rales v. Blasband, 634 A.2d 927, 933–34 (Del. 1993).

when the plaintiff has strong evidence that the officer breached fiduciary duties.

This curtailing of judicial oversight is sensible when the officer is subject to effective beneficiary oversight (i.e., when the officer is classified as an agent). But there is no justification to provide an officer with both an enhanced ability to receive beneficiary approval and with legal protections (such as the BJR) that are designed to compensate for the inability to receive beneficiary approval.

IV. CONCLUSION

In this Article, I analyzed officer fiduciary duties in light of my theory of corporate organs as an alternative mechanism to agency for maintaining the accountability of corporate actors. The distinction between the corporate organ and corporate agent regimes lies in the allocation of an oversight function, most importantly the discretion to determine whether an act on behalf of the corporation, which lies in the fiduciary duty penumbra (neither clearly faultless nor clearly faulty), had breached fiduciary duties.

Agency law, which relies on effective beneficiary oversight, empowers beneficiary oversight and restricts judicial oversight (to avoid imposing on the actor two conflicting masters). Organ law, which is superior to agency law in a second best world in which beneficiary oversight is ineffective, empowers judicial oversight and restricts beneficiary oversight.

Applying this theory to the debate on officers' fiduciary duties, the appropriate governance regime depends on the effectiveness of beneficiary oversight relative to judicial oversight of a particular officer. The beneficiary provides effective oversight of most officers, but the few officers who dominate the overseer can inflict on the corporation harm disproportionate to their numbers. Therefore, officers should not be uniformly classified as either agents or organs.

This Article argued that private ordering, through which corporations select the status of their officers, is likely to lead to the selection of the more effective regime in most cases—if the corporation and its officers are forced to choose between the two regimes. Unfortunately, the current status of officers provides officers with the benefits of both regimes—the ability to seek legal cover from the board or superior officers, as well as protections (such as the BJR) that are designed to compensate organs for the lack of beneficiary cover. Since officers currently receive the benefits of both regimes, they and the corporation have little incentive to select one of the regimes (and forego the benefits of the other).

Two relatively simple tweaks to the law should eliminate officers' ability to have their cake and eat it too. Both should apply only when officers benefit from the advantages of organ status (i.e., the BJR and higher thresholds for breach). In other words, they would only apply

when a corporation amended its charter to allocate some of the board's authority to an officer.

First, when an officer benefits from the advantages of organ status, she cannot rely on the approval (whether ex ante consent or ex post ratification) of the board to cure a breach of fiduciary duties. At most, a board's ratification would provide officers with the protection that a shareholder ratification provides directors; that is, reversal of burdens of proof, and, in some cases, the application of the BJR rather than entire fairness review.[83]

Second, when an officer benefits from the advantages of organ status, the *Aronson* standard[84] should apply to demand futility, rather than *Rales*.[85] In other words, demand would be excused if the plaintiff can show reasonable doubt that the underlying transaction (the officer's challenged conduct) was protected by the BJR. This would prevent a board from providing an officer with procedural cover by refusing to sue the officer.[86]

Applying these two changes would create a clear distinction between agent and organ status. Officers could opt to enjoy an organ's benefits (such as the BJR), but would not also benefit from an agent's broad ability to curtail judicial oversight through beneficiary approval. Forcing officers to make a tradeoff should lead to more efficient private ordering and a choice between two coherent governance frameworks.

83. Given that the organ status is optimized to govern officers who may dominate the board, public policy may dictate that organs would not receive any benefits from board ratification, and instead would have to seek shareholder ratification to reverse burdens of proof and/or shift standards of review.

84. *Aronson*, 473 A.2d at 814.

85. *See Rales*, 634 A.2d at 933–34.

86. A board may attempt to dismiss a derivative action, even if demand is excused, by creating a special litigation committee that finds the derivative lacks merit and petitions the court to dismiss it. Zapata Corp. v. Maldonado, 430 A.2d 779 (Del.1981). However, the *Zapata* test, in addition to inquiring as to the committee's independence and good faith, and to the bases supporting its conclusions, may also apply "its own independent business judgment, whether the motion should be granted." *Id.* at 789. The justification given by the *Zapata* court to this additional step—that "Under our system of law, courts and not litigants should decide the merits of litigation," *id.* at 789 n.18—upholds judicial oversight and curtails beneficiary oversight, precisely as it should under the logic of the law governing organs. Thus, special litigation committees operating under the *Zapata* rule are consistent with the policy of organ law, and do not need to be modified.