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Fuzzy Logic and Corporate Governance Theories

Abstract

Fuzzy logic is a theory that categorizes concepts or things belonging to more than one group. A methodology that explains how things function in multiple groups (not fully in one group or another) offers advantages when one definition or membership in a group accounts for belonging to multiple groups. A principal/agent model of corporate governance has some characterizations of fuzzy logic theory. The purpose of this article is to evaluate other models of corporate governance that account for the multi-agent role of senior officers of public companies and assess the accountability to the corporation. Corporate governance theorists continue to debate the inefficiency of agency theory, control costs, the role of management, and corporate purpose. This article furthers that discourse by examining an assumption within the principal/agent model of governance – that senior officers and directors owe the same fiduciary duties. Part II examines the incongruent nature of corporate purpose under the traditional principal/agent model of corporate governance and its role in fostering conflicts between the shareholders' and the corporations' interests. Part III then evaluates the stewardship theory. Part IV evaluates the mediating hierarchy theory of corporate governance. Finally Part V examines the judicial standards of review in Delaware – the business judgment rule, enhanced scrutiny, and entire fairness.

Keywords

Fuzzy logic, Corporate governance, Principal/agent model, Agency theory, Stewardship theory

Disciplines

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Fuzzy Logic and Corporate Governance Theories

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I. INTRODUCTION

Fuzzy logic is a theory that categorizes concepts or things belonging to more than one group.¹ A methodology that explains how things function in multiple groups (not fully in one group or another) offers advantages when no one definition or membership in a group accounts for belonging to multiple groups.² The principal/agent model of corporate governance has some characteristics of fuzzy logic theory.³

Under traditional agency theory of corporate governance, shareholders, directors, and senior corporate officers each belong to groups having multiple attributes.⁴ In the principal/agent model of corporate governance,

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1. See MASAO MUKAIDONO, *FUZZY LOGIC FOR BEGINNERS* (2001) (explaining fuzzy logic theory, its history, and uses). Described by the publisher “as a best-seller in Japan, enabling the reader to easily understand what fuzziness is and how one can apply fuzzy theory to real problems.” *Id.* at 17–19. “Fuzzy theory was invented by [Professor] L. A. Zadeh. The theory supports computer and math applications when the entire system cannot be precisely defined.” *Id.*

2. See *id.* at 25–29.

3. See generally Edward S. Adams & Daniel A. Farber, *Beyond the Formalism Debate: Expert Reasoning, Fuzzy Logic, and Complex Statutes*, 52 VAND. L. REV. 1243 (1999) (discussing fuzzy logic application to judicial decision-making in interpreting statutes); Deborah Jones Merritt, *The New Federalism after United States v. Lopez: Panel 1: The Fuzzy Logic of Federalism*, 46 CASE W. RES. L. REV. 685, 687–89 (1996) (discussing fuzzy logic application to Commerce Clause issues). Professor Merritt also references the following resources for understanding fuzzy logic on page 685, footnote 3 of her article, BART KOSKO, *FUZZY THINKING: THE NEW SCIENCE OF FUZZY LOGIC* (1993). See also DANIEL MCNEILL & PAUL FREIBERGER, *FUZZY LOGIC* (1993); Bart Kosko & Satoru Isaka, *Fuzzy Logic*, SCI. AM., July 1993, at 76.

4. See REINIER KRAAKMAN ET AL., *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH* 22 (2004); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, J. FIN. ECON., Oct. 1976, at 305, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=94043. Its foundational center is that shareholders are owners who engage directors to manage the firm. *Id.* at 309. It has at its core the notions of shareholder primacy and the maximization of shareholder wealth as the primary purpose of a corporation. *Id.* at 308. Directors and officers are agents of the shareholders, owing fiduciary duties to shareholders and indirectly to the corporation. *Id.* See generally Kenneth J. Arrow, *The Economics of Agency*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 37, 37–51 (John W. Pratt & Richard J. Zeckhauser eds., 1985) (indicating that agency is the mainstay of corporate governance doctrine); Melvin Avon Eisenberg, *Contractual Freedom in Corporate Law: The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1461 (1989) (“This article [considers] the legal rules that directly concern the internal organization of the corporation and the conduct of corporate actors. . . . [Its focus] is to develop the normative principles that determine which of the legal rules that concern the internal organization of the corporation and the conduct of corporate actors should be enabling or suppletory, and which should be mandatory.”).

shareholders are owners or principals; directors are shareholders and agents of the corporation; and senior corporate officers are directors' agents, shareholders' agents, and agents of the corporation.⁵ Each one functions within multiple groups serving multiple agency roles, and each owes fiduciary duties that vary depending on whose agent they are functioning as.

Such a multi-dimensional role for corporate actors is a consequence of multi-definitional corporate purpose within agency theory of governance.⁶ This multi-dimensional group membership is not easily reconciled within agency theory and is therefore not always explained.⁷ However, traditional corporate governance theory can borrow another basic tenet of fuzzy logic theory. Fuzzy theory not only accounts for membership in multiple groups, but also explains how things work because they are multi-dimensional or ambiguous.⁸ This article seeks to explain the ambiguities of corporate governance theory and suggests a framework that accounts for the multi-agent role of senior corporate officers of public companies. It offers a kind of fuzzy logic theory for understanding the fiduciary duties of senior officers.

The purpose of this article is to evaluate other models of corporate governance that account for the multi-agent role of senior officers of public companies and assess the ability of various models to hold senior officers accountable to the corporation. There are manifold consequences of corporate scandals in public companies including the increased criticism of executive officer conduct, federal regulations to monitor compliance with laws and codes of ethics by corporate officers, and the focus on state laws and fiduciary requirements that give shareholders greater voice in monitoring the performance of senior officers.⁹ Such increased attention on the

5. See KRAAKMAN ET AL., *supra* note 4, at 22; Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, in PRINCIPALS AND AGENTS, *supra* note 4, at 55, 56–57; see also Kent Greenfield, *New Principles for Corporate Law*, 1 HASTINGS BUS. L.J. 89, 91–92 (2005) (challenging the assumptions around corporate actor roles).

6. See KRAAKMAN ET AL., *supra* note 4, at 17–19; Clark, *supra* note 5, at 56–57; William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261, 264–65 (1992); Melvin A. Eisenberg, *The Conception that the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm*, 24 J. CORP. L. 819, 825 (1998).

7. See William T. Allen et al., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1067, 1070 (2002). In assessing the age old debate over corporate purpose, Delaware Chancery Court judges suggest that courts tend “to omit or blur the distinctions between contradictory ideas.” *Id.* See also Jonathan L. Johnson et al., *Boards of Directors: A Review and Research Agenda*, 22 J. MGMT. 409, 409–38, 410 (1996) (discussing the literature on the multiple roles of the board, management, and stockholders).

8. See MUKAIDONO, *supra* note 1, at 2.

9. See Kaja Whitehouse, *Move Over CEO: Here Come the Directors*, WALL ST. J., Oct. 9, 2006, at R1 (discussing board members becoming more involved in the companies they serve, leading to “better oversight” but “potentially strained relations with management”); see also John F. Olson & Michael T. Adams, *Composing a Balanced and Effective Board to Meet New Governance Mandates*, 59 BUS.

role of senior officers in public companies beckons a need to further the discourse by not only examining the fiduciary duties applicable to senior officers, but also the corporate governance structure that holds them accountable to the corporation.¹⁰

Corporate governance theorists continue to debate the inefficiency of agency theory, control costs, the role of management, and corporate purpose.¹¹ This article furthers that discourse by examining an assumption

LAW. 421, 437 (2004) (discussing legal, regulatory, and market pressures in the wake of corporate scandals shaping corporate governance policy and director behavior); David A. Skeel, Jr., *Icarus and American Corporate Regulation*, 61 BUS. LAW. 155, 159–62, 168–74 (2005) (assessing the merits of the Sarbanes-Oxley Act and other governance reforms and comparing American and English takeover regulations); George Anders, *Private Time*, WALL ST. J., Oct. 9, 2006, at R4 (discussing board meetings without management present, leading to “franker” discussions and “anxious CEOs”); Joann S. Lublin, *No One to Turn to*, WALL ST. J., Oct. 9, 2006, at R6 (discussing problems for directors when a CEO is ill or passes away); Lingling Wei, *How Am I Doing?*, WALL ST. J., Oct. 9, 2006, at R5 (examining the use of “[p]eer-based evaluations” among directors). See generally Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (referencing the Securities Exchange Act of 1934, 15 U.S.C. § 78(a) (2002)); Robert J. Jossen & Phillip M. Meyer, *Recent Developments in Securities Cases and Investigations*, in 1557 PLI/CORP 933, 940–42, 967–69 (2006) (discussing government investigations of senior executives); Gregory Scott Crespi, *Rethinking Corporate Fiduciary Duties: The Inefficiency of the Shareholder Primacy Norm*, 55 SMU L. REV. 141 (2002) (discussing the role of shareholders); Daniel J.H. Greenwood, *Enronitis: Why Good Corporations Go Bad*, 2004 COLUM. BUS. L. REV. 773, 782–95 (2004) (discussing the reasons for corporate failures); Joann S. Lublin & Phred Dvorak, *How Five New Players Aid Movement to Limit CEO Pay*, WALL ST. J., Mar. 13, 2007, at A1.

10. See Lawrence A. Hamermesh & A. Gilchrist Sparks, III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 BUS. LAW. 865, 867 (2005); see also Z. Jill Barclift, *Senior Corporate Officers and the Duty of Candor: Do the CEO and CFO Have a Duty to Inform?*, 41 VAL. U. L. REV. 269, 279–80, 291–92 (2006); Crespi, *supra* note 9, at 146; Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW. 439, 464–69 (2005); Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers are Fiduciaries*, 46 WM. & MARY L. REV. 1597, 1607–09 (2005).

11. See Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1, 9–10 (2002) [hereinafter Bainbridge, *The Board of Directors*] (discussing the early Berle/Means concepts of separation of ownership and control, the Coase theory, and the nexus of contracts model); Clark, *supra* note 5, at 55; George W. Dent, Jr., *Corporate Governance: Still Broke, No Fix in Sight*, 31 IOWA J. CORP. L. 39, 43 (2005) (discussing separation of ownership and control); Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 434–38 (1993); Greenfield, *supra* note 5, at 89–90 (2005); Daniel J.H. Greenwood, *Introduction to the Metaphors of Corporate Law*, 4 SEATTLE J. FOR SOC. JUST. 273, 288–93 (2005); Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439–440 (2001). The authors frame the debate early by listing five core structural characteristics of a business corporation (legal personality, limited liability, transferable shares, centralized management under a board, and shared ownership by contributors of capital), countering that these characteristics generate tensions and tradeoffs that give a distinctive corporate character to agency problems in corporate law. Hansmann, *supra*. See Bainbridge, *The Board of Directors*, *supra*, at 3–4; Crespi, *supra* note 9, at 144–49; Amir N. Licht, *The Maximands of Corporate Governance: A Theory of Values and Cognitive Style*, 29 DEL. J. CORP. L. 649, 651–56 (2004); see also KRAAKMAN ET AL., *supra* note 4, at 5–6, 17–19; Allen, *supra* note 6, at 266; Allen et al., *supra* note 7, at 1070–71; Stephen M. Bainbridge, *Response to Increasing Shareholder Power: Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006) [hereinafter Bainbridge, *Director Primacy*]; Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005) (“Bebchuk debates”); Leo E. Strine, Jr., *Response to Increasing Shareholder Power: Toward a True Corporate Republic: A Traditionalist Response to Bebchuk’s Solution for Improving Corporate America*, 119 HARV. L. REV. 1759 (2006). See generally William Bratton, *Berle*

within the principal/agent model of governance—that senior officers and directors owe the same fiduciary duties.¹² It also examines the standards of judicial review in Delaware applicable to senior officers and argues in support of a form of fairness as the standard of review to assess senior officer liability.

Part II examines the incongruous nature of corporate purpose under the traditional principal/agent model of corporate governance and its role in fostering conflicts between the shareholders' and corporations' interests. It assesses the shortcomings of agency governance theory for senior corporate officers and recommends a solution for the manager's dilemma.¹³

This article reviews two models of corporate governance that reject the principal/agent paradigm of governance. The two theories are the stewardship theory espoused by James H. Davis, F. David Schoorman, and Lex Donaldson, and the mediating hierarchy theory espoused by Margaret Blair and Lynn Stout.¹⁴ The article evaluates the ability of each theory to usher a governance framework for understanding the fiduciary duties of senior corporate officers of public companies.

Part III then evaluates the stewardship theory. This section examines the authors' meaning of stewardship and argues in support of the stewardship theory as a potential normative framework for understanding the fiduciary duties of senior officers of public companies. Further, this section then argues that senior corporate officers of public companies should be guided by the duty to act in the best interest of the corporation as stewards of public trust and less, if at all, in the best interest of the shareholders.¹⁵

Part IV evaluates the mediating hierarchy theory of corporate governance.¹⁶ This section argues in support of Blair & Stout's mediating hierar-

and Means Reconsidered at the Century's Turn, 26 J. CORP. L. 737 (2001); ASPEN INSTITUTE, CORPORATE GOVERNANCE AND ACCOUNTABILITY REPORT, http://www.aspeninstitute.org/site/c.huLWJeMRKpH/b.731125/k.2C5E/Corporate_Governance_and_Accountability.htm (last visited Sept. 22, 2007).

12. See KENT GREENFIELD, *THE FAILURE OF CORPORATE LAW: FUNDAMENTAL FLAWS & PROGRESSIVE POSSIBILITIES* 123–24 (2006); Clark, *supra* note 5, at 56–67; Johnson & Millon, *supra* note 10, at 1605–06, 1609.

13. See Leo L. Clarke et al., *The Practical Soul of Business Ethics: The Corporate Manager's Dilemma and the Social Teaching of the Catholic Church*, 29 SEATTLE U. L. REV. 139, 140 (2005) (defining the “Manager’s Dilemma” as that faced by corporate officers “who must choose between what their business judgment tells them is economically best for the employer and what their consciences tell them is morally right”).

14. James H. Davis et al., *Toward a Stewardship Theory of Management*, in *THEORIES OF CORPORATE GOVERNANCE: THE PHILOSOPHICAL FOUNDATIONS OF CORPORATE GOVERNANCE* 118 (Thomas Clarke ed., 2004); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

15. GREENFIELD, *supra* note 12.

16. See generally Blair & Stout, *supra* note 14.

chy as a framework for the role of directors of public companies.¹⁷ Redefining the role of senior officers necessitates redefining the role of directors of public companies in a way that accounts for senior officers as the agents of directors and the responsibility of the board to weigh multiple interests in decision-making. In addition, this section further argues that a combination of the two governance frameworks would accomplish the goals of each.

Finally, Part V examines the judicial standards of review in Delaware—the business judgment rule, enhanced scrutiny, and entire fairness.¹⁸ This section examines the policy rationales for the business judgment rule and argues that the policy rationales do not apply equally to officers and directors. It thus argues in support of fairness as the standard of review for senior officers. It further suggests that fairness is the standard of review within the governance framework called for by the stewardship and mediating hierarchy models.

II. AGENCY THEORY

A. Corporate Purpose

A fundamental tenet of the agency theory of governance is that corporate actors have a principal/agent relationship requiring controls to prevent the self-interested behavior of the agent.¹⁹ Thus, corporate actors are agents acting on behalf of the shareholder/principal.²⁰ Principals, therefore, rely on the corporate form and its centralized management to run the day-to-day affairs of the corporation and in return, establish agency controls to manage the self-interested behavior of agents.²¹ Hence, fiduciary

17. *Id.* at 255, 289–92. See GREENFIELD, *supra* note 12; Margaret M. Blair, *Reforming Corporate Governance: What History Can Teach Us*, 1 BERKELEY BUS. L.J. 1 (2004) (discussing the history of corporate governance); Dent, *supra* note 11, at 51–60 (commenting on team production theory as director focused and that its differences are merely semantic and focus is still on shareholder wealth maximization).

18. See generally E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992–2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, at 1421–53 (2005).

19. See GREENFIELD, *supra* note 12, at 50 (discussing corporate purpose). See generally Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23 (1991) (supporting the role of shareholders as residual claimants); *supra* notes 6, 11 and accompanying text for general reference.

20. See GREENFIELD, *supra* note 12, at 50 (discussing corporate purpose); Macey, *supra* note 19, at 23; see also *supra* notes 6, 11 and accompanying text for general reference.

21. See GREENFIELD, *supra* note 12, at 41–71 (discussing corporate purpose); Macey, *supra* note 19, at 23; see also *supra* notes 6, 11 and accompanying text for general reference. See generally Blair, *supra* note 17 (discussing the history of corporate governance).

duties are rooted in the obligation of the agent to have undivided loyalty and attention to the affairs of the principal.²²

Agency theory defines “management” as the agent of the shareholder—senior officers and directors.²³ Thus, directors and senior officers owe the same fiduciary duties to shareholders and the corporation.²⁴ These assumptions derive from the corporate form that separates ownership and control.²⁵ Senior officers are agents of the corporation because they control the actions of the corporation by legally binding the corporation and speaking on its behalf.²⁶ Hence, the corollary is that shareholders, as owners of the corporation, are the principals of senior officers. Senior officers are agents of the corporation and of the shareholders, and owe agent fiduciary duties—to act in the best interests of both.²⁷ A dual agent role of the corporate officer results in an incongruity of their fiduciary duties and in contradictory corporate purposes that are not always reconciled under agency theory.²⁸

Agency and contract theorists, constituency proponents, and others, each argue for a model of corporate governance that inherently focuses on corporate purpose to define fiduciary duties.²⁹ Understanding the purpose

22. Johnson & Millon, *supra* note 10, at 1606–07, 1629. Moreover, the principal/agent model does little to define the duties of senior officers based on their responsibilities within the corporation; instead, senior officers and directors are a collective body of agents owing the same duties to the entity and its owners. *See id.* at 1600.

23. *See* Johnson & Millon, *supra* note 10, at 1605–06. *See generally* DEL. CODE ANN. tit. 8 (2007); Marcel Kahan, *The Limited Significance of Norms for Corporate Governance*, 149 U. PA. L. REV. 1869 (2001) (discussing norms and incentives for corporate officers).

24. Johnson & Millon, *supra* note 10, at 1605–06, 1609. *See also* Thomas A. Smith, *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty*, 98 MICH. L. REV. 214, 243–44 (1999).

25. *See* Bainbridge, *The Board of Directors*, *supra* note 11, at 10–11.

26. *See supra* notes 6 & 11 and accompanying text for general reference on agency relationship; *see also* Bainbridge, *The Board of Directors*, *supra* note 11, at 16–17.

27. *See* GREENFIELD, *supra* note 12, at 42–43; *see also* MODEL BUS. CORP. ACT ANN. §§ 8.40–8.44 (2003) [hereinafter MBCA] (describing officers’ duties).

28. *See* Allen, *supra* note 6, at 271–72; Allen et al., *supra* note 7, at 1070–71; Crespi, *supra* note 9, at 149; Greenwood, *supra* note 11, at 288–92.

29. *See* Bainbridge, *The Board of Directors*, *supra* note 11, at 12–14 (discussing the challenges of the contractarian model of governance); Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595, 599–00 (1997); Hansmann & Kraakman, *supra* note 11, at 444–49 (discussing the various models of governance); David Millon, *Communitarians, Contractarians, and the Crisis in Corporate Law*, 50 WASH. & LEE L. REV. 1373, 1377–90 (1993) (discussing the contractarian and communitarian theories of governance). Communitarians argue that the public corporation owes its existence to the state and therefore owes certain duties to the public beyond shareholder wealth to the community and workers. *Id.* at 1381. *See* Susan J. Stabile, *Using Religion to Promote Corporate Responsibility*, 39 WAKE FOREST L. REV. 839, 848–55 (2004) (discussing the impact of religion on corporate structure). The contract model of corporate governance accepts the fundamental relationship between management and shareholders as one of principal and agent. Proponents of constituency models do not reject the principal and agent relationship between management and shareholders. While legislative solutions such as corporate constituency statutes offer guidance, these statutes do not offer any greater insight into the fiduciary duty of directors and officers when the best interests of the

of a corporation is integral to understanding the duties of directors and senior corporate officers.³⁰ The contradictory purpose within agency theory makes agency controls inefficient by increasing the monitoring costs of shareholders.³¹ Thus, if the purpose of the corporation is to maximize shareholder wealth, then agency and contract models view management's fiduciary duties as running exclusively to the shareholders.³² If the purpose of the corporation is to serve other societal goals and constituents, then the constituency model views management's fiduciary duties as running primarily to the entity.³³ Therefore, the fiduciary duties of directors and senior corporate officers depend on how well each manages the balancing of competing interests.³⁴

corporation and those of shareholders do not align. Courts must still choose a primary purpose based on shareholder primacy or look to the legislature to provide a counter balance to shareholder primacy. Allen, *supra* note 6, at 265–67, 276. *See generally* Dr. Ige Omotayo Bolodeoku, *Contractarianism and Corporate Law: Alternative Explanations to the Law's Mandatory and Enabling/Default Contents*, 13 CARDOZO J. INT'L & COMP. L. 433 (2005); Liam Seamus O'Melinn, *Neither Contract nor Concession: The Public Personality of the Corporation*, 74 GEO. WASH. L. REV. 201, 204 (2006) (arguing in support for a return to the public purpose of the corporation).

30. GREENFIELD, *supra* note 12, at 41. Most of the doctrine of shareholder supremacy focuses on the issue of ensuring "that management honestly and conscientiously serves the interest of shareholders." *Id.* *See* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 252 (1994) (discussing the concept of cross-ownership).

31. *See* Richard A. Booth, *Theory Informs Business Practice: Who Owns a Corporation and Who Cares?*, 77 CHI.-KENT L. REV. 147, 150–52 (2001) (discussing the history of the stockholder as owner).

32. Allen et al., *supra* note 7, at 1074–75; Millon, *supra* note 29, at 1378. Many of the gap fillers are found in state incorporation statutes and corporate articles of incorporation and by-laws. Millon, *supra* note 29, at 1375, 1378. Contractarians argue that the market for public corporations should dictate implicit contractual terms between management and shareholders. *Id.* at 1378. For contractarians, the relationship is less about fiduciary duties and more about contract rights. *Id.* This pyramid relationship, with shareholders at the top, works; however, connections are based on contract theory and not agency principles. *Id.* Directors are merely executing the terms of the contractual relationship as they manage the day-to-day affairs of the corporation. *Id.* *See* FRANK H. EASTERBROOK & DANIEL R. FISCHER, THE ECONOMIC STRUCTURE OF CORPORATE LAW 90–93 (1991); Crespi, *supra* note 9, at 146. Its primary focus is on the maximization of shareholders wealth with very little regulatory interference. Crespi, *supra* note 9, at 149–50. The nexus of contracts or contractarian theory analogizes the relationship among shareholders, directors, and the corporation as a collection of explicit or implicit contracts. *Id.* The judiciary's role is to fill any gaps in the bargaining power of the parties to the contract. *Id.* at 150. Contract theory, seeking to push notions of fiduciary principles out of the relationship, instead relies on explicit or implicit contract bargains between the parties. *Id.*

33. *See* Allen et al., *supra* note 7, at 1071. *See generally* GREENFIELD, *supra* note 12, at 125–52 (challenging many assumptions around the corporation).

34. *See* Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209, 1231–34 (1995) (discussing fiduciary duties as default rules); *see also* Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 880–82 (1988). *See generally* Leo E. Strine, Jr., *If Corporate Action is Lawful, Presumably There are Circumstances in Which it is Equitable to Take That Action: The Implicit Corollary to the Rule of Schnell v. Chris-Craft*, 60 BUS. LAW. 877 (2005).

B. Shareholder as Owner/Investor

Shareholders are the owners of the corporation because they are entitled to its residual assets in the event of liquidation.³⁵ In many ways, shareholders of the public corporation satisfy the quintessential attribute of owners within the corporate form.³⁶ They are largely diverse, uninvolved in managing corporate affairs, and focused primarily on wealth maximization.³⁷

Increasingly, shareholders of the modern public corporation are becoming investors.³⁸ Such owners expect directors to actively monitor senior officers and expect senior officers to focus on the long-term viability and profitability of the corporation.³⁹ Shareholders demand greater oversight and accountability from directors by insisting that directors know what senior officers are doing, thus resulting in increased disclosure requirements for public companies.⁴⁰ In turn, directors demand more accountability from senior corporate officers.⁴¹ However, shareholders exercise little direct control over senior officers and instead, must rely on directors to hire, fire, evaluate performance, and decide compensation.⁴²

35. See Booth, *supra* note 31, at 150–52 (analyzing the theory of stockholder ownership); Macey, *supra* note 19, at 23–24 (supporting the role of shareholders as residual claimants). See generally Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. DAVIS L. REV. 407 (2006) (arguing that the shareholders' rights to elect directors and to sell shares are the fundamental rights of a shareholder and thus deserve a great deal of respect and protection by law).

36. EASTERBROOK & FISCHER, *supra* note 32, at 1–8 (discussing the role of management and investors in the corporation). For a discussion distinguishing shareholders as either passive investors or active managers, see Booth, *supra* note 31, at 152. Booth states that the interests of the two types of shareholders may diverge; therefore, it may be difficult to know if the stockholder ownership theory applies to both types of shareholders. *Id.*

37. See Hansmann & Kraakman, *supra* note 11, at 452–54 (discussing the shifting role of shareholders in the public corporation).

38. See ROE, *supra* note 30, at 3–8 (discussing diffuse ownership); Blair, *supra* note 17, at 40–43.

39. See EASTERBROOK & FISCHER, *supra* note 32, at 1–8 (discussing the role of management and investors in the corporation); ROE, *supra* note 30, at 20–25 (discussing the diffuse types of investors in public corporations and examining the various models of corporate governance).

40. See Bainbridge, *Director Primacy*, *supra* note 11, at 1735; Bebchuk, *supra* note 11; Strine, *supra* note 11; see also ROE, *supra* note 30, at 3–8 (providing an introduction to a discussion on the meaning of diffuse ownership in public companies).

41. See ROE, *supra* note 30, at 3–8.

42. See Bainbridge, *Director Primacy*, *supra* note 11, at 1735; Bebchuk, *supra* note 11; Strine, *supra* note 11.

C. *More than One "Owner"*

Professional managers who are beholden to many corporate constituencies run the public corporation.⁴³ Management owes fiduciary duties to multiple constituencies, which in some cases equal or surpass those to shareholders.⁴⁴ The notion surrounding shareholder ownership of the corporation, which is rooted in the history of the corporate form, does not reflect the evolution of the public corporation.⁴⁵ It does not reflect the corporation's role in capital markets and the global economy of the United States, which has redefined the meaning of shareholder and the impact of capital markets in ensuring the long-term preservation of the organization.⁴⁶

The public corporation's reliance on the capital market for equity and debt has broadened the scope of fiduciary duties that management owes.⁴⁷ The regulation of the financial markets, with its emphasis on adequate disclosure, recognizes the duties of senior officers in running the affairs of the corporation in trust for multiple constituents.⁴⁸ Consequently, the assumption that senior officers are agents of the shareholders does not always explain that the organization is a separate legal entity with its own interests.⁴⁹ This leads to a difficulty in the agency model of governance for senior corporate officers—reconciling the shareholders' interests and the best interest of the corporation.⁵⁰

43. See GREENFIELD, *supra* note 12, at 125–52 (challenging many assumptions around the corporate form); ROE, *supra* note 30, at 1–9; Booth, *supra* note 31, at 156–57 (discussing other corporate interests).

44. See GREENFIELD, *supra* note 12, at 138–39; see also Booth, *supra* note 31, at 156–57 (discussing other corporate interests). See generally ROE, *supra* note 30, at 48–49.

45. See Booth, *supra* note 31, at 156–57 (discussing managers' conflict of interests); see also Marianne M. Jennings & Stephen Happel, *The Post-Enron Era for Stakeholder Theory: A New Look at Corporate Governance and the Coase Theorem*, 54 MERCER L. REV. 873, 892 (2003) (discussing stakeholder accountability).

46. See generally ROE, *supra* note 30, at 21–25 (discussing diffuse shareholder interests).

47. Crespi, *supra* note 9, at 149–52; Skeel, *supra* note 9, at 174–77. The corporate form separating professional management from investors demands that stakeholders limit direct involvement in corporate affairs except on certain fundamental issues. Skeel, *supra* note 9, at 175. Principal/agent theorists accept shareholder primacy as normative. *Id.* Critics of shareholder primacy argue that case law and corporate statutes do not always reflect a myopic focus on shareholder wealth. *Id.* See also Millon, *supra* note 29, at 1374–75 (discussing hostile takeovers and judicial response to managerial accountability).

48. Crespi, *supra* note 9, at 149–52; Skeel, *supra* note 9, at 174–77. See generally Greenfield, *supra* note 5, at 100–09.

49. See Clarke et al., *supra* note 13, at 149–50. Although it is suggested that the duties of senior officers are likely different from those of directors, judicial clarity is lacking on the nature and scope of their fiduciary duties. Barclift, *supra* note 10, at 279.

50. GREENFIELD, *supra* note 12, at 226–28. See PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01 (2007) [hereinafter PRINCIPLES OF CORPORATE GOVERNANCE]; ROE, *supra* note 30, at 235–37; see also *Prod. Res. Group, LLC v. NCT Group, Inc.*, 863 A.2d 772, 787–88 (Del. Ch. 2004).

D. *The Manager's Dilemma*

The manager's dilemma is the choice senior officers must make when deciding between shareholders' interests and the corporations' interests.⁵¹ This choice is a result of the incongruity of purpose within the agency model of corporate governance.⁵² Agency control costs are in place to ensure that other interests do not override shareholder interests because shareholder interests do not always align with the best interest of the entity.⁵³ The result is that the agency governance model compels senior corporate officers to both maximize shareholders' interests and act in the best interest of the corporate entity.⁵⁴ When those interests align, shareholders have little to complain about; however, as is often the case, when the interests do not align, shareholders expect their interests to trump other interests.⁵⁵ It becomes the role of the judiciary to evaluate how well senior officers have managed to balance the competing interests of the shareholders and the corporation, and their fiduciary obligations to each.⁵⁶ Not surprisingly, the courts do not always reconcile inconsistency.⁵⁷

E. *Why Eliminate the Manager's Dilemma?*

There is a need for a governance model that eliminates the manager's dilemma for senior corporate officers by redefining the principal/agent relationship between shareholders and senior officers. Such a governance theory would not align corporate officers with shareholders, but would require corporate officers of a public corporation to have an unrelenting commitment to the success of the organization. The singular focus of corporate officers on organizational success is unworkable within the principal/agent paradigm because of agency controls and the duality of corporate purpose.⁵⁸ Further, the continued evolution of the shareholder as owner to

51. MBCA, *supra* note 27; PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 50 (stating that officers and directors must act in the best interest of the corporation).

52. See Booth, *supra* note 31, at 156–57 (discussing managers' conflict of interests).

53. See GREENFIELD, *supra* note 12, at 226–28 (challenging many assumptions around the corporate form); EASTERBROOK & FISCHER, *supra* note 32, at 119–20.

54. See *supra* note 53.

55. See Crespi, *supra* note 9, at 147–48.

56. Allen et al., *supra* note 7, at 1071–73. For the past three decades, the Delaware courts have faced the “fundamental policy question that the Delaware General Assembly has not addressed[:] . . . mak[ing] a definitive choice between the two basic models of the corporation—the ‘property’ and the ‘entity’ models.” *Id.* at 1071. See also Strine, *supra* note 34, at 877–80.

57. See generally Allen et al., *supra* note 7, at 1067–99; Strine, *supra* note 34.

58. See E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393, 403–05 (1997) (setting a framework for tensions in corporate governance).

investor requires a new way of thinking about the reasons for the underlying fiduciary duties of senior officers.⁵⁹

As the dynamics of shareholders' ownership have changed, so have the responsibilities of directors and senior officers.⁶⁰ Directors must balance the interests of multiple public investors—equity owners and debt creditors.⁶¹ Similarly, senior corporate officers must manage short and long-term corporate interests to ensure the competitiveness of the corporation in a global market.⁶² Therefore, each must rely on and trust the other to focus on a singular task.⁶³ It is no longer sufficient to rely on agency cost controls to monitor behavior when directors and senior officers each claim to be acting in the best interest of the shareholders.⁶⁴

Senior officers must operate within a governance framework that evaluates their fiduciary duties based on their ability to carry out the best interest of the corporation; where the interests of the corporation do not agree with those of shareholders, senior officers must choose those of the corporation.⁶⁵ Senior corporate officers' responsibilities lack clarity within a principal/agent paradigm, which seeks to define all fiduciary duties based on the necessity of implementing agency control costs on behalf of shareholders. Senior officers are not the true agents of shareholders, but are the agents of directors charged with the singular task to steward the best interest of the corporate entity.⁶⁶ Because agency theory places senior corporate officers in the untenable position of choosing between the interests of shareholders and the entity, senior officers face ever-tightening agency controls if they choose not to allow the interests of shareholders to trump other interests.⁶⁷

Accounting for the duties of senior officers based on a narrow corporate purpose requires a redefinition of the role of senior corporate officers. Rejecting the agency framework for corporate governance is an initial step towards redefining the role of senior corporate officers. First, it allows for a methodology that views the function of directors and senior officers as

59. See generally GREENFIELD, *supra* note 12, at 125–52 (challenging many assumptions around the corporate form).

60. Johnson & Millon, *supra* note 10.

61. See generally ROE, *supra* note 30, at ch. 21.

62. *Id.* at 271.

63. See TAMAR FRANKEL, TRUST AND HONESTY: AMERICA'S BUSINESS CULTURE AT A CROSSROAD 73 (2006) (discussing trust in corporate culture); Richard C. Breeden, *New Governance Prescriptions, Restoring Trust: Report to the Hon. Jed S. Rakoff, the United States District Court for the Southern District of New York on Corporate Governance For the Future of MCI, Inc.*, in 1395 PLI/CORP 277 (2003).

64. See Blair, *supra* note 17, at 31–32; Blair & Stout, *supra* note 14, at 258–59.

65. See generally Johnson & Millon, *supra* note 10.

66. Clark, *supra* note 5, at 55.

67. See EASTERBROOK & FISCHER, *supra* note 32, at 7.

distinct—the director’s job is to monitor corporate choices and the senior officers’ job is to manage the entity. Secondly, it minimizes the manager’s dilemma by eliminating the dual agency relationship for senior officers. It offers the opportunity to limit senior officers’ fiduciary duties to only the corporate entity. Thus, directors can focus on their role as overseer for senior officers and make ultimate decisions to resolve disputes among competing interests.

The stewardship theory of Professors Davis, Schoorman, and Donaldson outlines a relational framework that centers on the corporate entity and relies on trust between senior officers and directors for control procedures. Such a framework views officers and board functions as distinct, and minimizes the manager’s dilemma.

III. THE MEANING OF STEWARDSHIP

In their 1997 article, the authors posit that stewardship theory differs from the agency model that views senior executives as rent seekers, self-interested, or “opportunistic.”⁶⁸ Instead, stewardship views the executive as motivated to serve the organization.⁶⁹ The authors explain that when the senior executive faces competing interests, she values cooperation and focuses on the best interest of the organization.⁷⁰ The executive accountable under stewardship recognizes and understands that the success of the organization will satisfy the interests of most of the constituents.⁷¹ Thus, the senior executive, as a steward, is “organizationally centered.”⁷²

A central aspect of stewardship theory is the re-positioning of the principal/agent relationship from one of “coercive power” to “personal power.”⁷³ The authors define “personal power” as influence that is sustainable over extended periods; they argue that “coercive power” is more common in the agency model of governance.⁷⁴ Therefore, a key element of

68. See Davis et al., *supra* note 14, at 120–21. See generally MAX L. STACKHOUSE, ON MORAL BUSINESS: CLASSICAL AND CONTEMPORARY RESOURCES FOR ETHICS IN ECONOMIC LIFE, 500–07 (Max L. Stackhouse et al. eds., 1995).

69. See Davis et al., *supra* note 14, at 120 (discussing the roots of stewardship theory in psychology and sociology). See generally Constance A. Bagley & Karen L. Page, *The Devil Made Me Do It: Replacing Corporate Directors’ Veil of Secrecy with the Mantle of Stewardship*, 36 SAN DIEGO L. REV. 897 (1999).

70. See Davis et al., *supra* note 14, at 120.

71. *Id.* at 121.

72. *Id.*

73. *Id.* at 124–25.

74. *Id.* at 125.

stewardship is the focus on a corporate structure based on trust and not the agency cost controls of the agency model.⁷⁵

The authors argue in support of a relationship between senior officers and directors based on steward-principal, rather than principal/agent.⁷⁶ It suggests that a relationship based on trust between the steward and principal aligns the director/officer relationship such that the senior officer is working to do what is best for the organization.⁷⁷ Moreover, the senior executive knows that she is “responsible for the fate of the corporation.”⁷⁸

Davis, Schoorman, and Donaldson’s stewardship theory offers the opportunity to restore trust in the relationship between senior officers and directors that is often lacking trust.⁷⁹ Further, stewardship theory minimizes the manager’s dilemma because the senior executive knows that her duty is to the organization and that the directors expect her to carry out this obligation. Restoring trust to corporate governance is necessary at a time when public corporations are under scrutiny.⁸⁰

Stewardship theory alone is not sufficient to redefine the responsibilities of senior corporate officers. In order for senior officers to focus on the singular goal of organizational success, they must know and understand how directors will evaluate their decision-making. The mediating hierarchy model is the second structural change in eliminating the incongruity of the agency theory because it redefines the role of directors.⁸¹

75. FRANKEL, *supra* note 63, at 73; GREENFIELD, *supra* note 12, at 176–79 (discussing inefficiency of shareholder primacy); Davis et al., *supra* note 14, at 121. *See also* Stabile, *supra* note 29, at 853–55 (discussing stewardship as a religious tenet).

76. *See* Davis et al., *supra* note 14, at 122; *see also* Kent Greenfield & Peter C. Kostant, *An Experimental Test of Fairness Under Agency and Profit-Maximization Constraints (with Notes on Implications for Corporate Governance)*, 71 GEO. WASH. L. REV. 983, 987–88 (2003) (discussing experiments and notions of fairness applied to corporate actors).

77. *See* Davis et al., *supra* note 14, at 129–30. The choice between agency and stewardship relationships is similar to the decision posed by a prisoner’s dilemma. *Id.* at 129. Such a dilemma leads to the following results: if mutual stewardship exists, potential performance of the firm is maximized. If a mutual agency relationship exists, potential costs of the firm are minimized. *Id.* at 130. If a mixed-motive choice exists, the party choosing stewardship is betrayed, and the party choosing activity is opportunistic. *Id.* *See generally* Lawrence E. Mitchell, *Fairness and Trust in Corporate Law*, 43 DUKE L. J. 425, 429 (1993).

78. *See* Davis et al., *supra* note 14, at 121.

79. *Id.*

80. *See* FRANKEL, *supra* note 63, at 176–79 (discussing the role of investors’ trust on management); Stabile, *supra* note 29, at 853–56 (discussing stewardship as a religious tenet).

81. *See generally* PRINCIPALS AND AGENTS, *supra* note 4 (discussing how agency theory works to provide legal remedies for the agency costs problem and promotes fairness based on fiduciary principles). These fiduciary principles are state mandatory and default rules set by the legislature in state incorporation statutes or “gap fillers” set by courts and tempered by the business judgment rule or some version of it. Gregory Scott Crespi, *Redefining the Fiduciary Duties of Corporate Directors in Accordance with the Team Production Model of Corporate Governance*, 36 CREIGHTON L. REV. 623, 633 (2003) (discussing Blair & Stout’s theory and its application to the fiduciary duties of directors). *See also* Clark, *supra* note 5, at 56–57. The judicial deference to management is an agency cost problem that makes director accountability elusive. *See id.*

Senior officers must know that a board's role, as ultimate overseer, is to reconcile competing corporate interests. Therefore, a stewardship model of corporate governance can only succeed if there is a redefined governance framework for directors.

Blair & Stout's model for corporate governance organizes contradictory notions of corporate purpose.⁸² The mediating hierarchy theory also rejects the principal/agent model.⁸³ It does this by defining the role of directors.⁸⁴ The mediating hierarchy theory also rejects the assumption under agency theory that senior officers and directors owe the same fiduciary duties.⁸⁵

82. See Blair & Stout, *supra* note 14, at 259–61. Many of the gap fillers are found in state incorporation statutes and corporate articles of incorporation and by-laws. *Id.* Contractarians argue that the market for public corporations should dictate implicit contractual terms between management and shareholders. Millon, *supra* note 29, at 1380.

83. See Blair & Stout, *supra* note 14, at 263–64 (explaining that shareholders are at the top of the hierarchy of corporate decision-making within in the principal/agent model). The authors state that although they are not managers of day-to-day business decisions, directors with statutory authority to monitor and make ultimate decisions on behalf of the corporation are at the top of the hierarchy of decision-making. *Id.* at 290–92.

84. See *id.* at 276–77 (discussing board's role as holding ultimate decision-making authority to select future corporate officers and directors, determine use of corporate assets, and serve as an internal "court of appeals" to resolve disputes among team members); see also Bainbridge, *The Board of Directors*, *supra* note 11, at 20–24. See generally Jensen & Meckling, *supra* note 4; David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811 (2001). Its foundational center is that shareholders are owners who engage directors to manage the firm. It has at its core the notions of shareholder primacy and the maximization of shareholder wealth as the primary purpose of a corporation. Directors and officers are agents of shareholders owing fiduciary duties to shareholders and indirectly to the corporation. Crespi, *supra* note 9, at 141–42. Corporate case law supports the principal/agent theory by attributing to directors and senior officers the duties of care, good faith, and loyalty. Although in many states such as Delaware, exculpation clauses limit the liability of directors for breach of the duty of care. Currently this protection does not extend to corporate officers in Delaware. It is the basis for the fiduciary duties management owes to shareholders. Blair & Stout, *supra* note 14, at 298–99. Two economists have identified several economic benefits of team theory: "streamlining information-gathering and decision-making, and controlling shirking through the cascade of sequential principal-agent contracts." *Id.* at 278. Mediating hierarchy theory argues that directors are not true agents of shareholders, but in fact corporate law gives directors great discretion in managing the public corporation. See Blair & Stout, *supra* note 14, at 280–82; see also Licht *supra* note 11, at 714–15.

85. See Blair & Stout, *supra* note 14, at 282 (discussing the expectation that most corporate decisions are made collegially among team members, or officers, at lower levels, rather than directors actually managing the corporation on a day-to-day basis). The authors state that the existence of a mediating hierarchy may increase incentives for team members to work out conflicts among themselves in order to avoid the dispute reaching the disinterested hierarch that may be potentially erratic or ill-informed. *Id.*

IV. THE MEANING OF “MEDIATING HIERARCHIES” AND THE ROLE OF DIRECTORS

A. *The Blair & Stout Theory*

Blair & Stout’s theory has as its key tenet the “mediating hierarchy” role of directors in public corporations—that is to mediate disputes among conflicting interests.⁸⁶ The authors argue that because the principal/agent model relies on knowing who are the principals and agents, it does not accurately define the function of corporate actors who often serve in multiple roles.⁸⁷

Blair & Stout argue that understanding the role of directors as the mediating hierarchy serves several beneficial purposes.⁸⁸ First, as an economic benefit it enhances agency control costs, efficient flow of information, and centralized decision-making.⁸⁹ Secondly, it allows directors to resolve conflicts between corporate players.⁹⁰ Thus, in the role of mediators, directors must “balance team members’ competing interests in a fashion that keeps everyone happy enough that the productive coalition stays together.”⁹¹ Directors then maintain ultimate control over corporate decisions with minimal influence from any one constituency.⁹² Directors’ fiduciary duties and the business judgment rule re-enforce the mediating role of the board.⁹³ Blair & Stout then argue that viewing directors more like

86. *Id.* at 280–81 (discussing role of directors as trustees for the corporation to balance competing interests). The authors base their article on team economic theories and argue team theory has several economic benefits including “streamlining information-gathering and decision-making, and controlling shirking through the cascade of sequential principal-agent contracts.” *Id.* at 278. See also Booth, *supra* note 31, at 151–52; Crespi, *supra* note 81 (discussing Blair & Stout’s theory and its application to the fiduciary duties of directors). See generally Thomas F. McInerney, *Implications of High Performance Production and Work Practices for Theory of the Firm and Corporate Governance*, 2004 COLUM. BUS. L. REV. 135 (2004).

87. Blair & Stout, *supra* note 14, at 259. See Bainbridge, *The Board of Directors*, *supra* note 11, at 28–29 (discussing the role of directors in monitoring team members); Jennings & Happel, *supra* note 45, at 877–78 (discussing shareholder accountability).

88. Blair & Stout, *supra* note 14, at 277–78. See Booth, *supra* note 31, at 151 (suggesting that stockholders and the market are mediating hierarchs); Crespi, *supra* note 81, at 634 (discussing role of the board in making decisions for the benefit of the corporate enterprise).

89. See Blair & Stout, *supra* note 14, at 278.

90. *Id.*

91. *Id.* at 281. See also Booth, *supra* note 31, at 157 (supporting Blair & Stout’s argument of the board as a mediator).

92. Blair & Stout, *supra* note 14, at 291–92. See Bainbridge, *The Board of Directors*, *supra* note 11, at 28–29 (discussing the role of directors to monitor team members).

93. Blair & Stout, *supra* note 14, at 316–18. See Bainbridge, *The Board of Directors*, *supra* note 11, at 30–31 (discussing the role of directors and the role of the business judgment rule).

trustees rather than agents imposes on directors the obligation to act "fairly and impartially."⁹⁴

Blair & Stout's theory redefines the role of directors as more like trustees whose job is to mediate conflicting purposes.⁹⁵ The mediating hierarchy theory offers a framework for corporate governance that centers on the idea that the purpose of a public corporation and the function of its board are to balance the interests of multiple constituencies.⁹⁶ The result is that incongruous purposes do not blur distinctions.⁹⁷ Instead, directors understand that their job is to balance the interests of all constituents and expect that senior corporate officers will advance the interests of the corporation.⁹⁸

Such a model explains what is ambiguous and aids directors and senior officers in understanding their role in corporate governance, in ways traditional agency theory has not.⁹⁹ It also aids stockholders who understand that directors work for the corporate team and without ultimate influence.¹⁰⁰ The purpose of the mediating hierarchy model is to develop a framework for understanding the role of the directors of a public company.¹⁰¹ However, Blair & Stout suggest that the mediating hierarchy role of directors discourages certain types of extreme "shirking" or "rent-seeking" behavior of executives.¹⁰² Thus, the mediating role of directors encourages senior executives to work for the good of the team.¹⁰³

Moreover, the mediating hierarchy appropriately places ultimate corporate decision-making within the hands of the board.¹⁰⁴ It therefore redefines the oversight role of directors, thus relieving officers of the obligation to balance corporate and shareholder interests.¹⁰⁵ The mediating hierarchy thus clarifies that while directors are more like trustees of shareholders, senior corporate officers as director agents are stewards of the organization.¹⁰⁶

94. Blair & Stout, *supra* note 14, at 316. One way to look at Blair and Stout's theory is that senior officers present corporate options to directors who must then in turn evaluate such options, weighing the interests of shareholders.

95. Blair & Stout, *supra* note 14, at 286.

96. *Id.* at 253. See also *id.* at 249-50 (explaining team theory); Millon, *supra* note 29, at 1378-79.

97. See Blair & Stout, *supra* note 14, at 253 (stating that the purpose of a board of directors is "not to protect shareholders per se, but to protect the enterprise-specific investments of all the members of the corporate 'team,' including shareholders, managers, rank and file employees, and possibly other groups, such as creditors").

98. *Id.* at 286, 291-92.

99. *Id.* at 291-92.

100. *Id.* at 254, 285-86, 290-92.

101. *Id.* at 251-52.

102. *Id.* at 280.

103. *Id.* at 283.

104. See *id.* at 290-92. The role of directors under the team theory is more like that of trustees resolving disputes between multiple constituencies. *Id.*

105. *Id.* at 289.

106. *Id.* at 289, 316.

The mediating hierarchy opens the opportunity to minimize the manager's dilemma for senior corporate officers and reduces the inherent incongruity of purpose under the principal/agent paradigm. Traditional ideas of corporate governance can be difficult to reconcile when multiple corporate actors each claim to be acting under the charge of one or both purposes.¹⁰⁷ Rearranging the paradigm of corporate governance to that of mediating hierarchs in the role of directors resolving conflicts seems to naturally lead to the role of senior officers as stewards.

The mediating hierarchy theory suggests that directors of public corporations have a great deal of control over corporate decisions and that they exercise this control by relying on corporate officers to speak for the best interest of the corporation.¹⁰⁸ Therefore, the purpose of the corporation is to advance the future of the entity, which benefits all constituents.¹⁰⁹ Thus, by defining directors of public corporations multi-dimensionally, it advances the opportunity to define senior corporate officers as stewards of the public trust, operating under the paradigm of the mediating hierarchy.¹¹⁰

B. *Advantages of Combined Theories*

The stewardship and mediating hierarchy governance models offer a framework for defining fiduciary duties in recognition of the different roles of senior officers and directors within a public company.¹¹¹ The agency

107. *Id.* at 258–59.

108. *See id.* at 315–16..

109. *See generally id.* (discussing duty of directors to act in the best corporate interest, the duty of loyalty).

110. *See* GREENFIELD, *supra* note 12, at 178–79 (discussing a need to encourage sharing and cooperation); Licht, *supra* note 11, at 714–15 (discussing limitations of the Blair & Stout arguments in reconciling fiduciary duties); *see also* Dent, *supra* note 11, at 43–44 (discussing managers' control of the corporation and power of the CEO to influence corporate decision-making).

111. *See* GREENFIELD, *supra* note 12, at 73, 176–80 (discussing the corporate experiment). As professional managers of public corporations, most CEOs understand that for the privilege of managing other people's money they are accountable to public shareholders. The consequence of having public investors and professional management is that the corporation loses the persona of the owner/entrepreneur and in essence, becomes ownerless. The law attributes rights of ownership to shareholders because without owners, who will protect the entity? Hence, it seems that in a circular logic, all corporate law really seeks to protect is the corporate entity itself. Any other benefits derived or obligations to the entity by other corporate actors are secondary to the continued existence of the corporation. Further, viewing senior officers as stewards of public trust better defines the multi-group membership and multi-definitional purpose of the public corporation. By defining the role of directors with the single purpose of mediating competing interests, a new paradigm of corporate governance more logically follows that defines the role of senior corporate officers of public companies. Thinking of a corporation formed in its infancy, imagine the entrepreneur who starts out with a smart idea to sell products or services. She selects the corporate form after obtaining advice from her accountants and lawyers. Without access to public market capital, she seeks friends, family, and professional colleagues as early investors and board members. These early shareholders often view the entrepreneur as

model creates a manager's dilemma because of its multiple corporate purposes.

Combining elements of the stewardship theory and mediating hierarchy offers several advantages over the traditional principal/agent model of governance. First, senior officers are agents of directors and not of multiple principals in a stewardship/mediating hierarchy model. Thus, senior officers owe direct fiduciary duties to directors and not shareholders.¹¹² This model rejects the idea that senior corporate officers and directors owe the same fiduciary duties.

Secondly, by redefining the role of directors as mediating hierarchs, directors monitor and resolve conflicting interests. Directors thus charge executives to serve as stewards of the organization and to advance corporate interest as their primary function. Because senior officers functioning under stewardship understand that their job advances corporate interests, they accept that directors will resolve conflicts between shareholder and entity interests.¹¹³ Senior officers must act in the best interest of the corporation, and less, if at all, on the best interest of the shareholders.¹¹⁴ The result is that their fiduciary duties center on an affirmative duty to provide timely, candid, and honest information to directors.¹¹⁵

Thirdly, this redefined framework minimizes the manager's dilemma. Because senior officers are obligated to meet the organizational goals set forth by directors, there is no longer a need to choose between the competing interests of shareholders and the corporation.¹¹⁶ It is up to the directors to decide how to balance competing interests.¹¹⁷ Directors then must re-

the owner of the business notwithstanding their rights as legal owners. Assuming the business is successful, as the business matures the owner decides to access public capital for future growth of the corporation. The reasons range from the desire to cash-out to growth limitations. Whatever the reasons for wanting public equity investors, upon going public, the persona of the corporation changes from one owned by the entrepreneur with known investors, to one managed by professionals owned by anonymous public shareholders. See ROE, *supra* note 30, at 252-53. Today, many public companies began as small businesses started by entrepreneurs that grew into big businesses.

112. See generally Arrow, *supra* note 4.

113. See Crespi, *supra* note 81, at 633-34 (discussing the impact of team production theory on director duties).

114. See *id.* at 634-35 (discussing impact of team production theory on the duties of loyalty and care).

115. See Bainbridge, *The Board of Directors*, *supra* note 11, at 31-33 (discussing importance of discretion in managing the affairs of the corporation).

116. See generally Jensen & Meckling, *supra* note 4.

117. See generally *id.* A corporate governance paradigm that links governance theories around the multiple roles of directors, we see how mediating hierarchy theory works to explain the fiduciary duties of multiple actors in multiple sets. Mediating hierarchy theory also interconnects entity and property theory in a way that helps us understand that when faced with competing corporate purposes, we can define a director's fiduciary duties as a way that accounts for what is ambiguous. Blair & Stout, *supra* note 14, at 262-64. See Crespi, *supra* note 81, at 634-35 (discussing impact of team production theory on the duty of loyalty and duty of care).

move officers who do not advance decisions that are in the best interest of the corporate entity and must actively monitor their performance in meeting corporate goals and fiduciary obligations to directors and the corporation.¹¹⁸

Such a paradigm has, as its key tenet, the need to manage the longevity of the corporate entity by organizing roles and duties around the continuation of the entity. Senior officers speak for the best interest of the corporation, shareholders vote in their own self-interest, and directors stand at the top of the hierarchy to resolve conflicts.¹¹⁹ Each corporate actor advances its own agenda, and it is up to directors to weigh and balance conflicts while looking to advance the interests of the team.¹²⁰ A combined theory thus accepts that corporate purpose is necessarily binary and involves a choice between competing purposes, but also recognizes that it is the job of directors to select the priority purposes based on the impact on shareholders.

Therefore, in a new paradigm of corporate governance, which embraces stewardship and mediating hierarchy, it is necessary to answer two basic questions. First, how do you hold senior officers accountable to the corporation under such a governance model that is a combination of stewardship and mediating hierarchy? Second, what is the proper standard of review for senior officers? Part V examines the standards of review and liability in Delaware and evaluates how such standards might work in a combined stewardship/mediating hierarchy model of governance.

V. BUSINESS JUDGMENT RULE, ENTIRE FAIRNESS, AND ENHANCED SCRUTINY IN DELAWARE

In a span of twenty years, the Delaware courts have continued to develop and refine the fiduciary duties of directors.¹²¹ The courts have examined the scope of the business judgment rule, and expounded on the standards of review in corporate control and interested-director transactions.¹²²

118. See Clark, *supra* note 5, at 56–57. The author of the article, Robert Clark, argues that directors are not agents of shareholders, and that officers are not direct agents of shareholders but are agents of directors who in essence are the corporation. Senior officers cannot operate in the best interest of the corporation and the best interests of shareholders simultaneously. See *generally id.*

119. See Blair & Stout, *supra* note 14, at 289–91. See *generally* Daniel P. Forbes & Frances J. Milliken, *Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-Making Groups*, 24 ACAD. MGMT. REV. 489 (discussing the research on the role of directors of public companies).

120. See Bainbridge, *The Board of Directors*, *supra* note 11, at 31–33. See *generally* Kahan, *supra* note 23 (discussing the norms and incentives for corporate officers).

121. See *generally* Veasey & Di Guglielmo, *supra* note 18.

122. *Id.*

However, Delaware courts have provided less specific guidance on the fiduciary duties of senior officers to directors, shareholders, or the corporation.¹²³ As a result, there is also less clarity on the standards of review applicable to the conduct of senior officers.

Delaware has three standards of review: business judgment, enhanced scrutiny, and entire fairness.¹²⁴ The business judgment rule is the judicial presumption that directors have met the standards of conduct for reasonable good faith decisions absent a showing otherwise.¹²⁵ The business judgment rule originates from a common law judicial doctrine indicating that a court will not substitute its judgment for that of the board to protect shareholders' interests, provided directors have reasonably acted in good faith in its decision-making in carrying out the best interests of the corporation.¹²⁶

Exceptions to the business judgment rule developed over the course of its inception to address the following circumstances: loyalty or self-interested transactions, transactions when the best interest of the corporation and the shareholders do not align, and business decisions when the corporation is insolvent or near insolvency.¹²⁷ Rebutting the business judgment presumption generally occurs in two circumstances: (1) enhanced scrutiny—when management takes defensive actions in response to a hostile takeover and the board seeks to sell or change control of the corporation, and (2) entire fairness—when there is self-interested conduct by agents or issues of loyalty.¹²⁸ Both standards apply when courts take a

123. Hamermesh & Sparks, *supra* note 10, at 867. See generally Johnson, *supra* note 10.

124. See Veasey & Di Guglielmo, *supra* note 18, at 1405–06, 1421–28.

125. See *id.* Several cases form the core of Delaware law on the obligations of directors in corporate takeovers and change of control. See, e.g., *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) (defining the range of conduct for management decisions in transactions that impact fundamental shareholder rights). See generally Janet E. Kerr, *Delaware Goes Shopping for a "New" Interpretation of the Revlon Standard: The Effect of the QVC Decision on Strategic Mergers*, 58 ALB. L. REV. 609 (1995) (discussing the history of key Delaware case law on takeovers and mergers).

126. Strine, *supra* note 34, at 884–94. See also *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000) (“Irrationality may be the functional equivalent of the waste test or it may tend to show that the decision is not made in good faith, which is a key ingredient of the business judgment rule.”).

127. Veasey & Di Guglielmo, *supra* note 18, at 1433. See generally *Credit Lyonnais Bank Nederland, N.V. v. Pathe Comm'n Corp.*, Civ. A. No. 12150, 1991 WL 277613, at *1 (Del. Ch. Dec. 30, 1991); DENNIS J. BLOCK ET AL., *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS* (4th ed. 1993 & Supp. 1995); Steven G. Bradbury, *Corporate Auctions and Directors' Fiduciary Duties: A Third-Generation Business Judgment Rule*, 87 MICH. L. REV. 276 (1988); Robert C. Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505 (1977); Johnson et al., *supra* note 7; Jonathan C. Lipson, *Directors Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 UCLA L. REV. 1189 (2003).

128. See *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 928 (Del. 2003); Veasey & Di Guglielmo, *supra* note 18, at 1454–58. See generally Thomas A. Smith, *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty*, 98 MICH. L. REV. 214, 223–24 (discussing, generally, fiduciary duties and the shift in fiduciary duties when a corporation becomes insolvent).

more expansive review of board decisions.¹²⁹ Both standards of review allow the court to not only assess the overall effectiveness of directors in balancing competing corporate interests, but also to evaluate their abilities in meeting fiduciary duties.¹³⁰

A. Business Judgment Rule

The primary rationale for the business judgment rule is to prevent judicial review of directors' decisions that do not involve conflicts of interest, the duty of loyalty, or otherwise involve issues of fairness to the corporation.¹³¹ The business judgment rule has two aspects: procedural and substantive.¹³²

The procedural aspect of the rule places the initial burden of proof on the complaining party to demonstrate that the director's conduct warrants

Two significant Delaware cases are *Credit Lyonnais Bank v. Pathe Communications Corp.*, 1991 WL 277613 (Del. Ch. 1991), and *Production Resources Group v. NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. 2004). *Credit Lyonnais* set off a round of criticism when the Delaware Chancery Court concluded that a corporation's directors "operating in the vicinity of insolvency" owe a dual duty to shareholders and the corporation. 1991 WL 277613, at *34. Later, in *Production Resources*, the court narrowed *Credit Lyonnais* by defining the nature of fiduciary duties owed to creditors when a corporation is insolvent or near insolvency. 863 A.2d at 797. The court then explained that directors' fiduciary duties include other constituencies. *Id.* at 797-98. In defining the fiduciary duties of directors when a corporation is solvent, the court used a team theory paradigm of corporate governance. *Id.* at 787. The court took the view that directors are to take into consideration multiple factors when making business decisions entitled to the protections of the business judgment rule. *Id.* at 787-88. The court, citing *Omnicare* as standing for the proposition that directors must weigh creditors and stockholders interest, further affirmed the team theory paradigm for corporate governance. *Id.* at 788 n.51. Thus, the court, based soundly in fiduciary principles, defined the duties of directors as a range of "prudent judgments" and rejected finding strict fiduciary rights owed to creditors by directors when a corporation is near insolvency. *Id.* at 788 n.52, 789.

129. See Blair & Stout, *supra* note 14, at 306-07; Veasey & Di Guglielmo, *supra* note 18, at 1458-61 (arguing that in cases where Delaware courts must reconcile shareholder rights with other corporate purposes, the courts are less likely to interfere with directors' decisions).

130. See MBCA, *supra* note 27; PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 50.

131. See William T. Allen et al., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1291-98 (2001); see also Zapata Corp. v. Maldonado, 430 A.2d 779, 782-83 (Del. 1981); Johnson, *supra* note 10, at 440 (arguing that the business judgment rule does not and should not be extended to corporate officers in the same broad manner in which it is applied to directors).

132. *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1162 (Del. 1995). See Allen et al., *supra* note 131, at 1295. The business judgment rule involves examination of duty to be informed and good faith. See *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 289 (Del. Ch. 2003). Knowing or deliberate indifference by a director to his or her duty to act faithfully and with appropriate care is conduct not in good faith, particularly when the directors know they are making material decisions without adequate information and adequate deliberation. *Id.* However, it is unclear under what standard senior officers would operate under in Delaware since section 102(b)(4) does not apply to them. See Melvin Avon Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 444 (1993) (discussing the business judgment rule).

further judicial review.¹³³ If the plaintiff rebuts the business judgment presumption, then the board must demonstrate that the challenged conduct meets the substantive entire fairness standard of review.¹³⁴ Meeting these procedural standards for rebutting the business judgment rule does not establish “per se” substantive liability.¹³⁵ Instead, the court must assess substantive liability.¹³⁶ Procedural rebutting of the business judgment rule is not, therefore, “outcome determinative.”¹³⁷ The board of directors is entitled to a judicial determination as to whether the board’s action was entirely fair.¹³⁸

Delaware’s exculpation statute allows a corporation to limit or eliminate director liability for a breach of the duty of care.¹³⁹ The effect of the exculpation provision has been to limit the scope of judicial review of director conduct to breaches of the duty of loyalty, good faith, or other intentional conduct.¹⁴⁰ Although the meaning of good faith and its limits on judicial review is beyond the scope of this article, entire fairness and enhanced scrutiny remain the standards by which the Delaware courts take a closer look at board decision-making.¹⁴¹

133. *Cinerama*, 663 A.2d at 1162. See also *In re Walt Disney*, 825 A.2d at 289 (discussing the meaning of good faith).

134. *Cinerama*, 663 A.2d at 1162. The standard for rebutting the presumption is that the: [D]ecisions will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to any rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available.

Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000).

135. *Cinerama*, 663 A.2d at 1162.

136. *Id.* at 1163.

137. *Id.*

138. *Id.*

139. DEL. CODE ANN. tit. 8, § 102(b)(7) (2007). The statute allows a provision to be inserted in the articles of incorporation which would “eliminat[e] or limit[] the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director” *Id.* However, the provision is only allowable if it does not eliminate or limit the liability of the director for any breach of the duty of loyalty, bad faith acts or acts that involve intentional misconduct or knowing violation of law, section 174 acts, or for self-interested transactions. *Id.*

140. See Janet E. Kerr, *Developments in Corporate Governance: The Duty of Good Faith and its Impact on Director Conduct*, 13 GEO. MASON L. REV. 1037, 1049 (2006); see also Veasey & Di Guglielmo, *supra* note 18, at 1432–36.

141. *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000) (stating that “[i]rrationality may be the functional equivalent of the waste test or it may tend to show that the decision is not made in good faith, which is a key ingredient of the business judgment rule.”); Allen et al., *supra* note 131, at 1301–02. See generally Lyman Johnson, *The Modest Business Judgment Rule*, 55 BUS. LAW. 625 (2000) (arguing that due care, not the business judgment rule, should be the focal point in the analysis of director fiduciary duty).

B. Entire Fairness

Entire fairness is a standard of judicial review invoked when there is sufficient evidence of a breach of the duty of loyalty, conflicts of interest, and disclosure.¹⁴² Entire fairness is a two-part test: fair deal and fair price.¹⁴³ The test is not bifurcated but is a review that examines the entire process by which the board carries out its duties.¹⁴⁴ In order for a court to find substantive liability under the entire fairness test, it must identify the fiduciary duty breached by examining the duties and processes by which the board satisfied its duties.¹⁴⁵ Thus, the court uses the entire fairness standard when self-dealing requires an evaluation of the fairness of a transaction based upon several factors, including whether independent directors approved the transactions.¹⁴⁶

C. Enhanced Scrutiny

Enhanced judicial review defines certain transactions as intrinsically unfair.¹⁴⁷ Such unfair transactions arise when the best interests of the corporation and maximization of shareholder wealth result in a conflict of interest for management, thus warranting a judicial review of actions outside the scope of the business judgment rule.¹⁴⁸ Typically, in corporate

142. *Cinerama*, 663 A.2d at 1163–64. See also *Emerald Partners v. Berlin*, 787 A.2d 85, 92–96 (Del. 2001); *Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289, 297 (Del. 1996); *Kahn v. Lynch Commc'n Sys., Inc.*, 669 A.2d 79, 82–89 (Del. 1995); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 709–14 (Del. 1983); *Kerr*, *supra* note 140, at 1040 (discussing the meaning of good faith); Edward B. Micheletti & T. Victor Clark, *Recent Developments in Corporate Law*, 8 DEL. L. REV. 17, 44–45 (2005) (discussing Delaware's exculpation provisions). See generally *Mitchell*, *supra* note 77, at 446–88 (discussing the meaning of entire fairness and self-dealing).

143. *Cinerama*, 663 A.2d at 1162–63; *Micheletti & Clark*, *supra* note 142, at 37–44 (discussing Delaware's standard of review).

144. *Cinerama*, 663 A.2d at 1162–63.

145. *Id.* at 1165.

146. See *id.* (discussing remand of breach of loyalty contentions to be sure both prongs of the entire fairness test are analyzed).

147. See *Veasey & Di Guglielmo*, *supra* note 18, at 1454–62. See generally *Kerr*, *supra* note 140.

148. See *Blair & Stout*, *supra* note 14, at 309–10 (arguing that Delaware case law supports the authors' theory of the mediating hierarchy); see also *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 928 (Del. 2003) (stating that there are certain circumstances which mandate that a court take a more direct and active role in overseeing the decisions made and actions taken by directors); *Blair & Stout*, *supra* note 14, at 305–06 (discussing mixed motives where directors appear to be using their corporate powers not to benefit the firm, but to benefit themselves); Andrew G.T. Moore, Jr., *The Birth of Unocal—A Brief History*, 31 DEL. J. CORP. L. 865, 873 (2006).

In *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), one of Delaware's early cases defining the standards of enhanced scrutiny, the court defined the scope of the business judgment rule. See *id.* at 949–59. The court defined the agency relationship between directors, shareholders, and the corporate entity, and recognized the underlying role of directors to act on behalf of the corporation. *Id.* at 954. The court acknowledged that directors must meet their underlying fiduciary obligations by considering multiple constituencies on the continuum of best interest of the corporation including the

control cases, directors are on both sides of the transaction and therefore, must defend their decisions not based on the exercise of reasonable business judgment, but on the higher standards of fairness.¹⁴⁹

Enhanced judicial review requires the court to weigh the best interest of the shareholders against the best interest of the corporation to determine whether directors have satisfied their fiduciary duties in corporate takeovers or change of control.¹⁵⁰ Courts assess the good faith of directors in carrying out their duties to be informed, monitor, inquire, and consider all viable options that benefit shareholders.¹⁵¹

shareholders. *See id.* at 954–59. Of particular significance is the court's conclusion that the Unocal board took all reasonable measures to inform themselves and acted in good faith in taking a defensive action designed to prevent a perceived harm to the corporation. *Id.* at 958–59.

Less than twelve months after the decision in *Unocal*, the court issued its opinion in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986). The issue was when should a board act in the best interest of the corporation and when it should maximize value for shareholders when deciding whether a company is for sale or defending against a hostile takeover. *See id.* at 179–85. The court agreed that *Unocal* permits directors to consider a range of corporate interests; however, the court will not allow a board tainted by self-interest to let the business judgment rule prevent an examination into the fairness of a hostile takeover transaction to shareholders. *See id.* The court reconciled *Unocal* by concluding that other corporate interests must be tempered by benefits to stockholders. *Id.* at 184. The facts of *Revlon* are significant because of the role of senior management in preventing the unwanted takeover raises issues as to whether management breached its duty of loyalty to shareholders. Ultimately, the court decided that the Revlon board had not adequately protected the interests of shareholders and had instead focused too heavily on protecting other corporate interests. *Id.* at 184–85.

Ten years after the decision in *Revlon*, the court further defined the meaning of enhanced scrutiny under the standards of *Unocal* and *Revlon*. In *Paramount Communications, Inc. v. QVC Network Inc.*, 637 A.2d 34 (Del. 1994), the court confirmed the application of enhanced judicial review in two circumstances: change of control, and defensive actions in response to a threat of change of corporate control. *See id.* at 41–52. In evaluating the continuum of options available to directors in a change of control, the court concluded that directors must be especially diligent to obtain information from those inside and outside the corporation, as well as evaluate all viable and available alternatives and their impact on the organization and its shareholders. *Id.* at 44–45. Thus, the court defined the factors of the enhanced scrutiny test as: adequacy of decision-making process and reasonableness of the directors' decisions in light of the circumstances. *Id.* at 45.

A year after the decision in *Paramount*, the court in *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361, 1374–88 (Del. 1995), defined the meaning of enhanced scrutiny under *Unocal*. The court concluded that the standard is a "flexible" standard, not subject to exacting measures. *Id.* at 1373–74. In determining whether a repurchase program was a proper defensive measure, the court focused on the applicability of *Unocal* for when the business judgment rule or enhanced scrutiny applied. *Id.* at 1374–75. The court concluded that provided directors' actions are not coercive or preclusive, the board is entitled to select from a range of reasonable decisions in weighing the best interest of the corporation and those of shareholders. *Id.* at 1387–88. The court concluded that a "range of reasonableness" allowed directors to include shareholders and the best interest of the corporation in deciding how to proceed in a takeover. *Id.*

149. *See sources cited supra* note 127.

150. *See Paramount*, 637 A.2d at 41–52.

151. Allen et al., *supra* note 131, at 1317.

D. Policy Rationales for the Business Judgment Rule

In deciding when the business judgment rule applies, courts often look to the policy rationales behind the business judgment rule.¹⁵² The business judgment rule's judicial presumption has two overarching policy rationales: that the judiciary should not second-guess business decisions, and respect for the delegation of authority to the board by shareholders in managing the business affairs of the corporation.¹⁵³ Case law and commentaries conclude that the fiduciary duties and standards of judicial review of senior officers is the same as for directors, and the rationales for its application to both are the same.¹⁵⁴ However, recent discourse suggests some debate on whether the business judgment rule is appropriate for senior officers.¹⁵⁵

Because the business judgment rule is a judicial policy favoring non-interference by courts in business decisions, the underlying policy rationales should also apply to senior officers. There are several policy reasons in support of its application to senior officers.¹⁵⁶ These reasons include: (1) encouragement of risk taking by management, (2) limiting judicial interference with business decisions, and (3) respect for the decision-making role of the board.¹⁵⁷ Each rationale connects to the other, which leads to a circularity that is less persuasive when applied to senior officers.

1. Encouragement of Risk Taking by Management

The business judgment rule encourages managerial risk taking by limiting judicial interference with business affairs.¹⁵⁸ When directors make business decisions, the rule protects directors from liability for good faith decisions, and in Delaware, the legislature allows the corporation to limit or eliminate liability for money damages for breach of the duty of care.¹⁵⁹ Thus, the business is managed without the unreasonable fear of judicial or shareholder interference. As a result, risky decisions that result in corporate growth are encouraged.¹⁶⁰

152. *Id.* See Hamermesh & Sparks, *supra* note 10, at 871; Johnson, *supra* note 10, at 458–69.

153. Allen et al., *supra* note 131, at 1317. See also Hamermesh & Sparks, *supra* note 10, at 871; Johnson, *supra* note 10, at 458–69.

154. Hamermesh & Sparks, *supra* note 10, at 871; Johnson, *supra* note 10, at 465.

155. See Hamermesh & Sparks, *supra* note 10, at 871; Johnson, *supra* note 10, at 458–69.

156. See Hamermesh & Sparks, *supra* note 10, at 870–75; Johnson, *supra* note 10, at 458–66.

157. Hamermesh & Sparks, *supra* note 10, at 870–75; Johnson, *supra* note 10, at 458–66.

158. See Hamermesh & Sparks, *supra* note 10, at 870–75; Johnson, *supra* note 10, at 458–66.

159. DEL. CODE ANN. tit. 8, § 102(b)(7) (2007).

160. Hamermesh & Sparks, *supra* note 10, at 870–71; Johnson, *supra* note 10, at 458–61.

Senior officers have a wide range of discretion in managing the business affairs of the corporation.¹⁶¹ Senior officers and directors work collaboratively, and it can be challenging to distinguish the senior officers' duties from those of the directors.¹⁶² Thus, it follows that the protection afforded to directors under the business judgment rule must apply equally, if not more stringently, to senior officers.¹⁶³ However, senior officers make many decisions within the scope of their duties that do not require board approval and may involve minimal board oversight.¹⁶⁴

In claims against senior officers, courts have concluded that shareholders must demonstrate that the conduct in question occurred solely in the capacity as an officer.¹⁶⁵ This leads to a narrow range of circumstances in which a shareholder might challenge the decision-making of senior officers as acting outside the scope of their duties and acting without approval of the directors.¹⁶⁶ Therefore, an analysis of its policy rationales to senior officers is limited to the narrow circumstances where a shareholder alleges a senior officer acting within the scope of her duties makes a decision that does not require board approval, but nonetheless harms the corporation. Such policy analysis does not include the broader circumstances when senior officers' decisions overlap with other possible claims against directors.¹⁶⁷ The goal is to assess the business judgment rule's appropriateness when senior officers are doing their jobs—running the corporation.¹⁶⁸

Risk taking is exactly what the board wants senior officers to do—to increase firm value.¹⁶⁹ Consequently, senior officers may be less inclined

161. See Dent, *supra* note 11, at 42–45 (discussing the managers' control of the corporation and the power of CEOs to influence corporate decision-making).

162. See Hamermesh & Sparks, *supra* note 10, at 872; Johnson, *supra* note 10, at 460.

163. Hamermesh & Sparks, *supra* note 10, at 872; Johnson, *supra* note 10, at 460.

164. See Hamermesh & Sparks, *supra* note 10, at 872–73; Johnson, *supra* note 10, at 459–61.

165. See *Arnold v. Soc'y for Sav. Bancorp, Inc.*, 650 A.2d 1270, 1286 (Del. 1994) (concluding that in order to hold senior officers liable for their acts or inaction, shareholders must demonstrate what decisions the senior officer made in her capacity as an officer); *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 289 (Del. Ch. 2003).

166. See Hamermesh & Sparks, *supra* note 10, at 870–72; Johnson, *supra* note 10, at 458–61. Such claims may allege director lack of oversight and may also involve breach of employment contracts or other claims against the officers. See *Lewis v. Vogelstein*, 699 A.2d 327, 330–31 (Del. Ch. 1997) (giving shareholder a cause of action when the board failed to disclose material facts when seeking shareholder ratification). Although shareholder ratification was not required for the authorization of the transaction, Delaware case law dealing with “fair process,” suggest[s] that a misdisclosure may make available a remedy, even if the shareholder vote was not required to authorize the transaction and the transaction can substantively satisfy a fairness test.” *Id.* at 330.

167. See generally *In re Walt Disney*, 825 A.2d at 275.

168. See Hamermesh & Sparks, *supra* note 10, at 872–73; Johnson, *supra* note 10, at 458–61. Excluded from this discussion is the Johnson & Hamermesh argument that directors can sue officers. Hamermesh & Sparks, *supra* note 10, at 871. The focus is not on the directors' claims against officers for violations of employment agreements or breach of duties to directors, but breach of duties to shareholders. *Id.* at 872.

169. See Hamermesh & Sparks, *supra* note 10, at 870–71; Johnson, *supra* note 10, at 458–61.

to take risks if all decisions require board approval.¹⁷⁰ Except for decisions requiring shareholder approval, boards have a great deal of discretion to decide what matters senior officers must submit to the board for review or approval.¹⁷¹ Thus, not all senior officers' decisions are subject to board approval or review.¹⁷² However, ultimate risk taking decisions rest with the board and not senior officers.¹⁷³ Therefore, the business judgment rule applied to senior officers' decisions (including decisions not to act) might prevent a shareholder from challenging a corporate decision that did not require board approval but perhaps should have.¹⁷⁴

2. Limiting Judicial Interference with Business Decisions

Protecting senior officers' decisions from hindsight judicial bias is as important as protecting board decisions from judicial second-guessing.¹⁷⁵ However, if senior officers act within the scope of their duties without board approval, absent judicial review, there is the potential for very little oversight of senior officer conduct in circumstances where the board reasonably did not know it needed further inquiry into senior officers' decision-making.¹⁷⁶ There is a greater need to examine certain corporate decisions that may not have had any oversight.¹⁷⁷

Currently in Delaware, there is a greater risk of hindsight review for senior officers because the exculpation statute does not apply to them.¹⁷⁸ Senior officers risk liability for ordinary negligence in circumstances where directors may not be liable.¹⁷⁹ Such a result is unfair to officers acting within their scope of duties, especially when directors ratify decisions.¹⁸⁰ As such, senior officers should be included within the limitation of liability provisions lest a senior officer risks liability for a lesser standard of conduct (simple negligence) than the board.¹⁸¹ Therefore, senior

170. Hamermesh & Sparks, *supra* note 10, at 870–71.

171. *Id.* at 871; Johnson, *supra* note 10, at 454–55.

172. Hamermesh & Sparks, *supra* note 10, at 871; Johnson, *supra* note 10, at 455.

173. DEL. CODE ANN. tit. 8, § 141(a) (2007).

174. *See* Hamermesh & Sparks, *supra* note 10, at 871; Johnson, *supra* note 10, at 455.

175. Hamermesh & Sparks, *supra* note 10, at 873–74; Johnson, *supra* note 10, at 462–63.

176. *See* Hamermesh & Sparks, *supra* note 10, at 873–74; Johnson, *supra* note 10, at 462–63.

177. Hamermesh & Sparks, *supra* note 10, at 874.

178. *See id.* at 873 (disagreeing with Lyman P.Q. Johnson); *see also* DEL. CODE ANN. tit. 8, § 102(b)(4) (2007); Dennis R. Honabach, Smith v. Van Gorkom: *Managerial Liability and Exculpatory Clauses: A Proposal to Fill the Gap of the Missing Officer Protection*, 45 WASHBURN L.J. 307, 324–25 (2006) (discussing the extension of exculpatory provisions to corporate officers); Johnson, *supra* note 10, at 461.

179. Hamermesh & Sparks, *supra* note 10, at 874; Johnson, *supra* note 10, at 462–65.

180. Hamermesh & Sparks, *supra* note 10, at 874.

181. *See id.* at 875 (stating that it is important that all decisions do not come to the board). There is a risk to officers for simple negligence. *See* Johnson, *supra* note 10, at 467–68 (discussing Virginia law

officers should be subject to the same standards of good faith and loyalty as are directors in order to assess their conduct in meeting obligations to the corporation.¹⁸²

If the business judgment rule is going to apply to the conduct of senior officers, they should be included within the limitation of liability provisions of an exculpation statute.¹⁸³ However, given the mix of procedural and substantive aspects of the business judgment rule, realistically, the court may likely evaluate the substantive merits before concluding the procedural deference.¹⁸⁴ As a result, the issues to resolve focus on the standard of liability, and whether the officers can demonstrate good faith processes in their decision-making.¹⁸⁵ This necessarily leads to an analysis on whose behalf the senior officer acts. This also leads into the next policy rationale.

3. *Respect for Decision-Making Role of the Board*

When the board makes a decision in reliance on information from senior officers, judicial deference for the board's decision is consistent with the statutory requirements for the scope of board functions.¹⁸⁶ There is no legislative mandate to defer to the decisions of senior officers.¹⁸⁷ When the board is not involved in decision-making, shareholders have no direct way to challenge senior officers.¹⁸⁸ There is the risk that in such narrow cases the business judgment rule would prohibit any review of senior officers' decisions.¹⁸⁹ Unlike directors, who formally make decisions to act or not act, a board's acts or omissions are subject to challenge by shareholders. Senior officers, on the other hand, make decisions that are subject to little direct oversight.¹⁹⁰

that includes officers); *see also* Hamermesh & Sparks, *supra* note 10, at 874 (stating that not holding officers to a standard that differs from directors can be risky); *id.* at 876 (acting beyond scope of duties and good faith); Honabach, *supra* note 178, at 325.

182. Johnson, *supra* note 10, at 461 (arguing for an ordinary care standard). *But see* Hamermesh & Sparks, *supra* note 10, at 866 (failing to argue for an ordinary care standard).

183. Hamermesh & Sparks, *supra* note 10, at 872-73; Johnson, *supra* note 10, at 461.

184. Hamermesh & Sparks, *supra* note 10, at 873-74; Johnson, *supra* note 10, at 463.

185. *See* Hamermesh & Sparks, *supra* note 10, at 873-74; Johnson, *supra* note 10, at 463.

186. Hamermesh & Sparks, *supra* note 10, at 875; Johnson, *supra* note 10, at 464.

187. *See* Hamermesh & Sparks, *supra* note 10, at 875.

188. *Id.* at 875; Johnson, *supra* note 10, at 465.

189. *See generally* Johnson, *supra* note 10, at 454 (discussing application of the business judgment rule as applied to officers); David Rosenberg, *Galactic Stupidity and the Business Judgment Rule*, 32 J. CORP. L. 301 (2007) (discussing the business judgment rule and standards of review).

190. Blair & Stout, *supra* note 14, at 291-92. *See* Bainbridge, *The Board of Directors*, *supra* note 11, at 30-32 (discussing the role of directors and the need for discretion in decision-making).

E. *Standards of Review and Senior Officers*

The policy rationales for application of the business judgment rule to directors are not as persuasive when applied to senior officers.¹⁹¹ Given the information advantage of senior officers and the wide range of discretion to make business decisions without director approval, the business judgment rule has the potential to limit the review of senior officers' actions in circumstances warranting such review.¹⁹² In circumstances where the business judgment rule limits judicial review, courts have relied on loyalty and intrinsic conflicts of interest to warrant enhanced judicial review.¹⁹³ Senior officers' decisions, not otherwise monitored, are appropriate for enhanced judicial review when facts suggest that a reasonable deliberative process did not occur, or failed even without a breach of the duty of loyalty.¹⁹⁴

1. *Enhanced Judicial Review*

Entire fairness and enhanced scrutiny allow the court to assess the fairness of a transaction.¹⁹⁵ Enhanced judicial review is the appropriate standard of review in circumstances when senior officers' decision-making is not subject to director oversight.¹⁹⁶ It recognizes the intrinsic conflict or the manager's dilemma that senior officers face and therefore allows for judicial review in circumstances where the business judgment rule does not convincingly warrant a judicial policy of non-interference with business decision-making.

Entire fairness and enhanced scrutiny require the court to assess a variety of factors for fairness.¹⁹⁷ Specifically, the court must determine how well directors or officers engaged in a "reasonable deliberative process" designed to protect the interests of the corporation and shareholders.¹⁹⁸ Thus, in circumstances where there is very little oversight of senior offi-

191. See Hamermesh & Sparks, *supra* note 10, at 876; Johnson, *supra* note 10, at 469.

192. See Johnson, *supra* note 10, at 469.

193. Veasey & Di Guglielmo, *supra* note 18, at 1428–29. See also *supra* note 128 and accompanying text.

194. See Allen et al., *supra* note 131, at 1317–20.

195. See *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1162–63, 1165 (Del. 1995) (explaining that the business judgment rule is both procedural and substantive); Micheletti & Clark, *supra* note 142; see also *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988) (explaining under what circumstances the business judgment rule fails to protect board decisions); *supra* note 148 and accompanying text.

196. See Veasey & Di Guglielmo, *supra* note 18, at 1424–25.

197. See *supra* note 149 and accompanying text.

198. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985); see also Allen et al., *supra* note 7, at 1067–68.

cers' business decisions, a corporate governance framework that defines fiduciary duties based on corporate roles rather than agency principles may offer a framework that minimizes the manager's dilemma and rejects the idea that senior officers and directors owe the same fiduciary duties.¹⁹⁹

F. Fairness: Stewardship and Mediating Hierarchy

Fairness or enhanced scrutiny is an appropriate standard of review for evaluating the conduct of senior officers under a combined stewardship/mediating hierarchy framework.²⁰⁰ When senior officers manage the corporate enterprise for its long-term success, there is an intrinsic conflict that calls for an examination of whether personal interests are in conflict with corporate interests.²⁰¹ Therefore, in circumstances where there was no director review of senior officers' decisions, enhanced scrutiny is the judicial equivalent of mediating hierarchy.²⁰²

Enhanced judicial review to examine senior officer decision-making processes that are not subject to director review is an appropriate standard of review in order to determine liability. This would not necessarily put officers at a greater risk of liability, but would put them on notice to additional review by those speaking for the corporation.²⁰³ Further, application of either entire fairness or enhanced scrutiny tempers officer conduct.²⁰⁴

VI. CONCLUSION

A basic tenet of fuzzy logic theory accounts for, and explains, multi-group membership.²⁰⁵ Although the agency model of governance accounts for multi-group membership, it does not always explain incongruity.²⁰⁶ Therefore, this article argues that stewardship theory, when combined with the mediating hierarchy model, offers a kind of "fuzzy logic" theory for explaining the duties of senior management in public companies.²⁰⁷

199. See generally Allen et al., *supra* note 7.

200. See Greenfield & Kostant, *supra* note 76, at 987 (discussing experiments and notions of fairness applied to corporate actors); Mitchell, *supra* note 77, at 436–41.

201. See Blair & Stout, *supra* note 14, at 305–10 (discussing the meaning of "mixed motives" and balancing competing interests).

202. *Id.* at 311–14.

203. See generally sources cited *supra* note 10.

204. *Id.*

205. See MUKAIDONO, *supra* note 1.

206. See Allen, *supra* note 6, at 264–65.

207. There are two views on the principal/agent doctrine of corporate laws. Traditional theorists view the judiciaries' role as to protect the interests of shareholders limiting the ability of "management" to exploit its control over shareholder ownership. See Millon, *supra* note 29, at 1374.

This combination model holds senior officers accountable for acting only in the long-term best interests of the corporation, and makes directors responsible for monitoring corporate choices and deciding how to resolve conflicting interests. Thus, senior officers' fiduciary duties require them to act in the best interest of the corporation and provide information to directors. As a result, unlike the agency theory, the combined model accounts for and explains the ambiguities of corporate purpose.

The combined theories further provide a framework for entire fairness as the standard of review for senior officers' conduct in circumstances where there is no director oversight, and the policy rationales of the business judgment rule otherwise limit judicial review. This not only gives shareholders a voice to monitor the conduct of senior officers, but it is also far more predictable than the substantive versus procedural distinction. It further encourages a corporate governance environment for decision-making that is consistent with the standards of review in Delaware.²⁰⁸

208. See MBCA, *supra* note 27, §§ 8.40–8.44 & commentary; PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 50.

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